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No. 07-_____

In The

Supreme Court of the United States

LEHMAN BROTHERS BANK, FSB,

Petitioner,

v.

STATE BANK COMMISSIONER,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Delaware

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the Delaware State Bank Commissioner violate the principles of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and the Commerce and Due Process Clauses of the United States Constitution, when he taxed 100% of a multi-state bank's net income, even though only a minimal part of the bank's activities occurred in Delaware, with such in-State activities generating on average only 2% of the bank's income, while $106 million of income taxes were paid to other state and local jurisdictions?

RULE 29.6 STATEMENT

Petitioner, Lehman Brothers Bank, FSB, was 100% owned by Lehman Brothers Bancorp Inc., which was 100% owned by Lehman Brothers Holdings Inc., during the tax years 2000, 2001, 2002, and 2003, the tax period involved in this dispute. Lehman Brothers Holdings Inc. is a publicly held company with no parent company or publicly held company owning more than 10% of its stock.

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PETITION FOR A WRIT OF CERTIORARI

Lehman Brothers Bank, FSB ("Lehman Bank") respectfully petitions this Court to grant a writ of certiorari to review the November 9, 2007 opinion of the Supreme Court of the State of Delaware, which modified its November 7, 2007 opinion.

OPINIONS BELOW

The opinion of the Supreme Court of Delaware dated November 9, 2007 (App. 1a-48a), modified its opinion of November 7, 2007 (App. 49a-95a). The opinion dated November 9, 2007 is not officially reported. The opinion dated November 7, 2007 is reported at 937 A.2d 95. The opinion and order of the Superior Court of Delaware, New Castle County (App. 96a-134a), dated November 30, 2006, is not officially reported. The findings and decision of the State Bank Commissioner (App. 135a-174a) are not officially reported.

JURISDICTION

The opinion of the Supreme Court of Delaware was entered on November 7, 2007, and was modified by the court on November 9, 2007. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution provides: "The Congress shall have power . . . [t]o regulate Commerce with foreign nations, and among the several states, and with the Indian tribes." U.S. Const. art. 1, § 8, cl. 3.

The Due Process Clause of the United States Constitution provides: "No state shall . . . deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1.

An excerpt from the relevant Delaware State statute is set forth at App. 175a-179a.

STATEMENT OF THE CASE

This case raises the question whether the U.S. Constitution permits Delaware to tax 100% of a multi-state bank's net income notwithstanding that on average only 2% of the bank's income was generated from activities occurring in that State, and even though other state and local jurisdictions tax the bank on virtually all of the same income that Delaware is taxing in full.

Despite a long line of United States Supreme Court decisions to the contrary, the Delaware Supreme Court held that the State Bank Commissioner could tax a multi-state bank on all of its income, without relief for double taxation, irrespective of

where the bank's income-generating activities took place. The Delaware court's decision directly conflicts with the decisions of this Court, under both the Commerce Clause and the Due Process Clause, which require that a state income tax be fairly apportioned so that it is imposed on only income from a taxpayer's in-state activities. It is of vital importance that this Court intervene to prevent the erosion of this bedrock principle, which is contradicted by the Delaware court's decision.

This Court has consistently held, under the principles of *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), that an income-based tax must be fairly apportioned so that it reaches "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." *Goldberg v. Sweet,* 488 U.S. 252, 261 (1989). While the Delaware Supreme Court acknowledged that the constitutional limitations in *Complete Auto* apply, the court nonetheless held that the State Bank Commissioner could tax 100% of Lehman Bank's net income without violating the Commerce Clause. The Delaware court also held that taxing 100% of the bank's net income did not violate the Due Process Clause.

By disregarding the apportionment requirement and taxing 100% of Lehman Bank's net income, the State Bank Commissioner clearly violated the Commerce Clause by ignoring the location of the bank's multi-state activities that generated that income. Moreover, by failing to grant relief for the $106 million

of income taxes paid to other states and localities, the Commissioner ignored the resulting multiple taxation, which is intended to be mitigated by the constitutional apportionment requirement.[1] In addition, by ignoring the apportionment requirement, the Commissioner violated the Due Process Clause by "reach[ing] profits which are in no just sense attributable to transactions within" the State. *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 134 (1931). *See also Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) (stating that an income tax must be apportioned to "actually reflect a reasonable sense of how income is generated"). The Delaware Supreme Court sanctions blatant unconstitutional overreaching, as well as double taxation, by the Commissioner. The court's decision, if allowed to stand, would eliminate the Due Process and Commerce Clause protections of corporations that conduct a multi-state business.

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[1] Although the Delaware Supreme Court accepted the State Bank Commissioner's finding that the evidence adduced was insufficient to prove that the income taxed by Delaware was also taxed by other states, the Commissioner never questioned the proof offered by Lehman Bank that it paid a substantial amount of income taxes to other state and local jurisdictions. Furthermore, PricewaterhouseCoopers LLP, an independent CPA firm, verified that "the vast majority of [Lehman Bank's] income was being taxed in New York State and other jurisdictions" (App. 210a), and that more than $106 million in state and local income taxes were paid. Since the Commissioner never questioned Lehman Bank's undisputed proof of those taxes paid, it was disingenuous to describe Lehman Bank as not having sufficiently proved this fact.

A. The Delaware Bank Franchise Tax

Delaware imposes a bank franchise tax on the net earnings of a "banking organization" ("bank") for the privilege of doing business in the State. Lehman Bank is a federally chartered savings bank. Delaware measures the tax for a federal savings bank having its "principal office" in Delaware by taxing all of the bank's taxable income, except for income earned from the bank's "branches" or "subsidiaries" outside the State where the income is subject to tax in another state. Del. Code Ann. tit. 5, §§ 1101(a) and 101(4)(b). No apportionment is allowed for any activities performed by such bank outside of Delaware at offices that are not considered "branches" or "subsidiaries," even if virtually all of the bank's income is earned outside the State. The measure of the tax is different for a federal savings bank not "headquartered" in Delaware. In that instance, the bank is taxed only on the net income earned from the bank's branches located in Delaware. Del. Code Ann. tit. 5, § 1101(b). The Delaware Supreme Court held that Lehman Bank's "principal office" was in Delaware and that therefore the bank could exclude out-of-state income only if earned from out-of-state "branches" or "subsidiaries."

B. Lehman Bank's Business

The material facts in this case are not in dispute.

In July 1999, Lehman Brothers Holdings Inc. ("Holdings"), through its direct subsidiary, Lehman

Brothers Bancorp Inc., acquired the Delaware Savings Bank, FSB, a failing federally chartered savings bank, which it renamed "Lehman Brothers Bank, FSB." The acquisition required and received the approval of the United States Office of Thrift Supervision ("OTS"). Before (and after) it acquired the bank, Holdings and its affiliates operated a successful mortgage banking business and was recognized as one of the top providers of mortgage-backed securities on Wall Street. By purchasing the bank, Holdings and its affiliates gained access to Federal Home Loan Bank ("FHLB") funding for its mortgage business.

Lehman Bank, as a federally chartered savings bank, was not created under the laws of Delaware or any other state. However, its federal stock charter states that its "home office" is in Wilmington, Delaware. This designation, which was based on the "home office" designation of Delaware Savings Bank, FSB, determines the bank's location for OTS regulatory purposes. Another consequence is that it determines which one of the 12 regional federal home loan banks provides funding to Lehman Bank. By having its "home office" in Delaware, Lehman Bank obtains funding from the regional FHLB located in Pittsburgh, which has jurisdiction over the states of Delaware, Pennsylvania and West Virginia.

At all relevant times, Lehman Bank had two distinct operations—a very profitable mortgage banking business conducted entirely outside of Delaware, and a small retail banking business conducted entirely in Delaware.

Lehman Bank conducted its mortgage banking business by acquiring or originating mortgages. The bank customarily held these mortgages for 45-60 days, after which the mortgages were sold to an affiliate for securitization. Approximately 97% of Lehman Bank's income was interest income earned on these mortgages.

Lehman Bank conducted its mortgage banking business outside of Delaware. Approximately 100 individuals were employed in the conduct of that business, none of whom worked in Delaware. All of Lehman Bank's executive officers, except for its senior vice president for retail banking, worked in New York. All of the meetings of the bank's board of directors were held in New York. All of Lehman Bank's headquarters' activities were conducted in New York. None were conducted in Delaware. Lehman Bank's retail branch in Delaware did not originate, service or fund Lehman Bank's mortgage banking activities.

C. Filing Position and Delaware Tax Assessments

For the tax years 2000 through 2003, Lehman Bank filed its Delaware bank franchise tax returns reporting income to the State in the same manner in which the Delaware Savings Bank, FSB filed before it was acquired by the Lehman organization, and in the manner that the State Bank Commissioner had previously accepted. In conforming with its predecessor's

filing methodology, Lehman Bank limited its exclusion of income from its out-of-state activities to 50%. For the four years in issue, it paid Delaware bank taxes totaling nearly $17 million. Following a review of those tax returns, the State Bank Commissioner assessed additional tax against Lehman Bank, aggregating more than $10 million for the four year period, by taxing 100% of Lehman Bank's net income. The Commissioner also assessed substantial penalties. Lehman Bank subsequently filed amended tax returns by applying a separate accounting methodology based on a study prepared by Ernst & Young LLP to determine the bank's income from Delaware operations, and claimed tax refunds of approximately $14 million.

D. The Proceedings Below

Lehman Bank protested the State Tax Commissioner's assessment. After informal conferences, the State Bank Commissioner approved his own assessment. Lehman Bank then challenged the assessment at an evidentiary hearing conducted by the same State Bank Commissioner who had previously issued the assessment.[2] The evidentiary record contains studies prepared by Ernst & Young LLP (App. 180a-206a)

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[2] In Delaware, for taxes other than bank tax and property tax, evidentiary hearings are held before an independent Tax Appeal Board. For the bank tax, however, the State Bank Commissioner conducts evidentiary hearings, and is the sole arbiter, on challenges of his assessments.

and PricewaterhouseCoopers LLP (App. 207a-220a). The separate accounting study prepared by Ernst & Young showed on average only 2% of Lehman Bank's income was earned in Delaware. The income attributable to Delaware based on the separate accounting study, and under the State Bank Commissioner's methodology, was as follows:

Sourcing Method	2000	2001	2002	2003
Separate Accounting	9,245,346	3,470,998	8,065,575	8,600,649
Commissioner's 100% Sourcing	113,095,000	226,173,000	406,201,000	666,507,000

The study prepared by PricewaterhouseCoopers verified that Lehman Bank paid more than $106 million in state and local income taxes in those state and local jurisdictions in which it conducted its nationwide mortgage banking business (App. 220a):

State Tax[3]	2000	2001	2002	2003	Total
California	3,638,546	2,697,004	3,916,657	6,301,284	
Colorado	6,802	-	621,964	1,205,380	
Florida	47,848	-	382	-	
Louisiana	10	10	53,249	57,936	
Maryland	344,768	99,627	486	500	
Minnesota	-	-	-	21,174	
New York State	8,012,802	7,195,628	10,090,349	18,690,000	
New York City	7,193,832	6,777,166	9,451,295	19,794,292	
Oregon	848	10	25,191	121,131	
Tennessee	100	100	100	100	
Totals	19,245,556	16,769,545	24,159,673	46,191,797	106,366,571

[3] For taxes paid to California, Colorado and Minnesota, where the unitary Lehman Brothers group of affiliated companies pay tax collectively, Lehman Bank's tax was computed based on its contribution to the group's unitary income.

After the evidentiary hearing, the State Bank Commissioner sustained his earlier assessment in its entirety, and determined that Lehman Bank was taxable on 100% of its net income. He concluded that the bank's out-of-state income from its mortgage banking business did not qualify for the exclusion for net income earned from out-of-state "branches" or "subsidiaries." The Commissioner also determined that the bank was not entitled to Commerce Clause protection other than parity in taxation between federally chartered banks and state banks. Lehman Bank appealed to the Delaware Superior Court, which upheld the Commissioner's findings and decision.

Lehman Bank appealed to the Delaware Supreme Court. Although it was undisputed that all of the bank's mortgage banking activities were conducted outside the State, the Delaware court rejected Lehman Bank's Commerce Clause and Due Process Clause claims and upheld the taxation of 100% of Lehman Bank's net income. The Delaware court found that the "branch" and "subsidiary" income exclusions available under the Delaware law were sufficient to satisfy the constitutional "fair apportionment" requirement, and that taxing all of the bank's income "'reasonably' reflects the in-state component of its activity." (App. 24a.) The court concluded that the "branch" and "subsidiary" income exclusions were not available to Lehman Bank. Rather, the court held that out-of-state earnings from

non-branch, non-subsidiary mortgage banking activities could be taxed in full by Delaware.

The Delaware Supreme Court held that Delaware may tax 100% of a multi-state bank's net income, and that this is fully consistent with the "fair apportionment" requirement for Commerce Clause purposes set out in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977).[4] The opinion holds that the Delaware tax is "fairly apportioned" through what the court refers to as the Delaware statute's "'structural' apportionment" methodology, a term that has not been used previously by any court. (App. 31a.) The decision also holds that Delaware has a "'reasonable' economic justification for imposing the tax" (App. 37a) on all of the bank's net income from its mortgage banking business based on the court's belief that some of the funds were borrowed from the Pittsburgh FHLB due to "the [b]ank's domiciliation in Delaware." (App. 35a.) Finally, the decision holds that there is a "rational relationship" between the income being taxed and the protections and benefits given by the State sufficient to satisfy the Due Process Clause. (App. 40a.) These holdings are irreconcilable with the long-standing decisions of this Court and vitiate the concept of "fair apportionment."

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[4] The Delaware Supreme Court properly rejected the State Bank Commissioner's principal argument below that federal savings banks are not entitled to *any* Commerce Clause protection.

The Delaware Supreme Court, concluding that the State Bank Commissioner abused his discretion by refusing to abate the penalties, reversed the portion of the lower court's decision upholding the assessment of penalties and remanded the case for further proceedings on the penalties. The court observed at oral argument that the penalties appeared to be "piling on." The penalty issue is not part of this Petition.

REASONS FOR GRANTING THE PETITION

The decision of the Delaware Supreme Court presents a question of considerable national significance to all corporations having activities in more than one state: whether the Delaware State Bank Commissioner violated the principles of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and the Commerce and Due Process Clauses of the United States Constitution, when he taxed 100% of a multi-state bank's net income even though its in-state activities generated on average only 2% of such income. The case is especially critical to multi-state banks because the Delaware statute is based on an outmoded and irrelevant assumption about how banks generate their income. The Delaware court's decision challenges the continued validity of this Court's decisions in *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948), and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Delaware court's decision ignores the more than $106

million of income taxes paid to other states and localities, resulting in double taxation. This Court has recognized that fair apportionment is "the lineal descendant" of the prohibition against multiple taxation that was articulated in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 260 (1938). *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995).

In holding that the out-of-State "branch" and "subsidiary" exclusions satisfy the "fair apportionment" requirement, the decision also undermines this Court's holding in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), that unconstitutional discrimination is not cured merely because the taxpayer *could have* structured its business differently—here, by establishing "branches" or "subsidiaries" outside Delaware—so as to avoid the discrimination. Finally, because Lehman Bank is a federally-chartered bank, the decision places in issue whether a state may treat such a bank as a domiciliary, and if so, whether it may tax a domiciliary on all of its income, including that earned in other states, while granting no relief for double taxation.

In order to halt any erosion of the principle that a state is prohibited under the Commerce Clause and Due Process Clause from overreaching by taxing income earned outside its borders, it is critical that this Court review the Delaware court's decision.

I. THE DELAWARE COURT'S DECISION DISREGARDS LONG-STANDING SUPREME COURT PRECEDENT AND IF NOT REVERSED WILL REMOVE THE PROTECTIONS GRANTED BY THE FAIR APPORTIONMENT MANDATE AND LEAD TO DOUBLE TAXATION

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), this Court stated that in order to satisfy the requirements of the Commerce Clause, a tax must (i) be applied to an activity with a substantial nexus with the taxing state; (ii) be fairly apportioned; (iii) not discriminate against interstate commerce; and (iv) fairly relate to the services provided by the state. Under the second "prong" of *Complete Auto*, a state income tax must be fairly apportioned to "ensure that each State taxes only its fair share of an interstate transaction." *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989); *see also Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

This Court struck down a New York tax on transportation services that did not permit a bus company to apportion its receipts from interstate transportation services. *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948). Furthermore, this Court struck down a North Carolina corporate income tax when the tax, "as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion

to the business transacted by the appellant to that State." *Hans Rees' Sons v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 135 (1931); *see also Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n,* 390 U.S. 317, 325 (1968) (striking down as unconstitutional a property tax apportionment formula that did not "bear a rational relationship . . . to property values connected with the taxing State").

The Delaware Supreme Court's decision sanctions Delaware's taxation of 100% of Lehman Bank's income without taking into account that nearly all of the bank's income-generating activities—including the origination, purchase and sale of the mortgages that generated almost all of the bank's income—took place outside Delaware. The decision also sanctioned the resulting double taxation. The taxation of income not fairly attributable to the bank's income-generating activities within Delaware, with the resultant multiple taxation, violates the Commerce Clause and Due Process Clause and conflicts with this Court's decisions and the decisions of various state courts. The Delaware Supreme Court has cast a pall over all interstate businesses, which this Court should remove. This Court should intercede and clarify that its decisions in *Complete Auto*, *Central Greyhound* and *Hans Rees'* are the law of the land.

The Delaware court observed that this Court has not yet decided whether a state may constitutionally tax the unapportioned net income from a multi-state "domiciliary entity." Despite this, the Delaware court allowed the Commissioner to treat Lehman Bank as a

domiciliary and tax it on 100% of its income, without any relief for double taxation. The Delaware court's decision is even more egregious in light of the fact that Lehman Bank is a federally chartered bank, and therefore not a Delaware domiciliary. While the Delaware court did not directly hold that Lehman Bank was a Delaware "domiciliary" and therefore taxable without apportionment, it may be inferred that this was part of the court's conclusion, particularly since the State Bank Commissioner had argued that Delaware could tax the entire income of a *domestic* bank, whether or not the bank engaged in income-generating activities in another state.

In support of this dubious conclusion, the Delaware court cited the Rhode Island Supreme Court decision in *Commercial Credit Consumer Services, Inc. v. Norberg*, 518 A.2d 1336 (R.I. 1986), which upheld as constitutional a former unapportioned Rhode Island bank tax on a bank incorporated under Rhode Island law. This aberrant decision is based on the flawed conclusion that the state of domicile may deny fair apportionment to a corporation, even if that corporation conducts business in other states. Such an extraordinary proposition is inconsistent with this Court's Commerce Clause doctrine barring unapportioned income-based taxes. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 444 (1980). In *Mobil*, this Court rejected Mobil Oil's claim that Vermont could not tax its dividend income because New York, as the state of its legal and commercial domicile, could tax Mobil on all its dividend income.

Applying a Commerce Clause analysis, this Court stated:

> [W]e may assume, for [the] present purposes, that the State of commercial domicile has the authority to lay *some tax* on appellant's dividend income. . . . These are the circumstances in which apportionment is ordinarily the accepted method.

Id. at 445-46 (emphasis added).

A related issue requiring this Court's intervention is the Delaware court's holding that the Delaware tax was fairly apportioned because Delaware law permits a bank to exclude income earned from an out-of-state "branch" or "subsidiary." The court's rationale is erroneous, and conflicts with Supreme Court precedent. The tax that is actually applied to a taxpayer must satisfy the Commerce Clause and Due Process Clause. That a taxpayer could have reorganized itself to avoid an unconstitutional tax is irrelevant.

The State Bank Commissioner would have permitted Lehman Bank to exclude income earned at an out-of-state "branch" or "subsidiary." But Lehman Bank was able to earn its income without a "branch" or "subsidiary"—two specific forms of doing business that were not necessary for the bank to carry out its mortgage banking activities under modern banking law. It is of no consequence that the constitutional requirements *would have been met* had the bank conducted its affairs differently by operating through

an out-of-state branch or subsidiary. *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 78 (1992). The Delaware court erroneously accepted two particular *forms* of conducting business (a "branch" or "subsidiary") as a proxy for *how* income was actually earned. In the modern era of multi-state banking, however, substantial income can be earned without the use of a "branch" or "subsidiary," as the facts in this case indicate, and as evidenced by the payment of $106 million of income taxes to other states and localities. This Court should intervene to make clear that *Kraft* remains good law and that a state tax must meet constitutional requirements as applied to the taxpayer, and not require a taxpayer to conduct itself in some less efficient form of business organization in order to avoid double taxation.

Delaware is the only state that denies banks the right to apportion income unless the banks earn their income through an out-of-state "branch" or "subsidiary."[5] Delaware's idiosyncratic statute as interpreted by the State Bank Commissioner virtually ensures there will be multiple taxation. Every other state taxes a bank on income earned in that state, based on an apportionment formula, while Delaware taxes 100% of the bank's income, wherever earned, unless earned through an out-of-state "branch" or "subsidiary." This

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[5] Effective for tax years beginning on or after January 1, 2007, the Delaware legislature established an elective alternative franchise tax calculation method permitting apportionment.

risk of multiple taxation violates this Court's rationale in *Western Livestock,* as incorporated by the fair apportionment requirement.

The Delaware Supreme Court also affirmed the Delaware Superior Court's erroneous holding that taxing 100% of Lehman Bank's income did not violate the Due Process Clause of the U.S. Constitution. Under the Due Process Clause, a state cannot tax transactions and income which are not "rationally related" to the taxpayer's in-state activities, and for which the taxpayer does not derive commensurate state protections and benefits. *See Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978); *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. 207 (1980); *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992). This Court has held that it will strike down a tax under the Due Process Clause if it seeks to "reach profits which are in no just sense attributable to transactions within [the taxing] jurisdiction." *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 134 (1931).

By taxing 100% of Lehman Bank's income, notwithstanding the bank's minimal in-state activities relating to that income, and the minimal services and protections provided by the state, the Commissioner violates the Due Process Clause. The Due Process Clause's rational relationship requirement cannot be met where the Commissioner seeks to tax 100% of the bank's income even though only approximately 2% of its income was attributable to the in-state activities of Lehman Bank.

The requirement of fair apportionment is just as vital to determining whether a tax satisfies the Due Process Clause as to whether it satisfies the Commerce Clause. This Court should therefore intervene to prevent the evisceration of the Due Process Clause protections.

II. WITHOUT FURTHER REVIEW, THE DELAWARE DECISION, WHICH DECIDES AN IMPORTANT CONSTITUTIONAL QUESTION, WILL CONFLICT WITH DECISIONS OF OTHER STATES' HIGHEST COURTS.

In holding that the State Bank Commissioner may tax a multi-state corporation without permitting apportionment, the Delaware Supreme Court has created a clear conflict with the decisions of state courts in Pennsylvania, Virginia, California, Arizona and Colorado.

These state courts have consistently struck down unapportioned income and business activities taxes as unconstitutional. In *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108 (Pa. 2003), the Pennsylvania Supreme Court held that the imposition of the Philadelphia gross receipts tax on the unapportioned gross receipts of the Eagles football team's share of receipts from television broadcasters, where only half the team's games were played in Philadelphia, violated the fair apportionment requirement. The same result was reached in *Northwood Construction Co. v. Township of Upper*

Moreland, 856 A.2d 789, 805 (Pa. 2004), *cert. denied*, 544 U.S. 962 (2005), where the Pennsylvania court invalidated a business activity tax as "plainly taxing more than that 'portion of the revenue from [Northwood's] interstate activities which reflect the instate component of the activity being taxed' as it is taxing all of the revenues from Northwood's interstate activities." (Citation omitted.) The tax violated the Commerce Clause because it "'reach[ed] beyond that portion of value that is fairly attributable to economic activity within the taxing State.'" *Id.* (citation omitted). The Virginia Supreme Court has also held that the Commerce Clause prohibits a city from imposing an unapportioned gross receipts tax when only a portion of the activities that generated those receipts were conducted within the city. *City of Winchester v. American Woodmark Corp.*, 471 S.E.2d 495 (Va. 1996).

Courts in other states have reached similar conclusions regarding the constitutional right to fair apportionment. *See, e.g., Northwest Energetic Servs., LLC v. Franchise Tax Bd.*, No. CGC-05-437721, Cal. St. Tax Rep. (CCH) ¶ 403-999 (Cal. Super. Ct. San Francisco County Apr. 13, 2006) (striking down a California tax as unconstitutional because it did not contain an apportionment mechanism to prevent the taxation of out-of-state income); *City of Modesto v. National Med, Inc.* 128 Cal. App. 4th 518 (2005) (holding a city business license tax unconstitutional as applied because it taxed business activities occurring outside of the city); *General Motors Corp. v. City*

of Los Angeles, 486 P.2d 163 (Cal. 1971) (where the California Supreme Court held it was improper to impose a Los Angeles gross receipts tax on a wholesaler's gross receipts from sales to customers within the city without apportioning those receipts to reflect the taxpayer's out-of-city selling activities), *appeal dismissed,* 404 U.S. 1008 (1972); *Southern Pac. Transp. Co. v. Department of Revenue*, 44 P.3d 1006 (Ariz. Ct. App. 2002) (requiring apportionment of an Arizona transaction privilege tax on gross receipts from railroad shipments that originated and terminated in Arizona, but that traveled a route that passed through New Mexico); *General Motors Corp. v. City & County of Denver*, 990 P.2d 59, 71 (Colo. 1999) (holding that apportionment must take into account the location where revenue is generated).

The Delaware Supreme Court decision conflicts with these state court decisions on whether the Constitution requires that a multi-state taxpayer's income be fairly apportioned. It is irrelevant that the above cases involve gross receipts taxes and not income taxes: a gross receipts tax "is simply a variety of tax on income, which [is] required to be apportioned to reflect the location of the various interstate activities by which it was earned." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 190 (1995). Other than Rhode Island, no state has had the audacity to pretend that a tax on 100% of a multi-state bank's business was fairly apportioned. This Court should intervene to avoid conflict among the states in the application of the Commerce and Due

Process Clauses, which apply equally to all states, including the state of Delaware.

CONCLUSION

The Delaware statute reflects an earlier era when banks were restricted in where and how banking activities could be conducted. The statute does not contemplate that banks could diversify their businesses and engage in activities other than through "branches" or "subsidiaries." In today's environment, the Constitution prevents Delaware from interpreting its statute to tax 100% of a multi-state bank's income when nearly all of the activities generating that income took place in other states. Delaware cannot tax 100% of Lehman Bank's income and ignore the more than $106 million of income taxes paid to other states and localities on part of the same income that Delaware is taxing in full. The decision of the Delaware Supreme Court conflicts with the decisions of this Court and of other state courts. The Commerce Clause and the Due Process Clause establish the ground rules that govern every state's taxing powers in our federalist form of government. In this case, the Delaware State Bank Commissioner is overreaching by attempting to rewrite long-established legal precedent.

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Dated: February 1, 2008

APPENDIX A

SUPREME COURT OF DELAWARE

MEMORANDUM

FROM: Justice Jacobs

TO: Cathy L. Howard, Clerk

DATE: November 9, 2007

RE: *Lehman Brothers Bank, FSB v. State Bank Commissioner* No. 656, 2006

Please substitute the attached Modified Opinion for the Opinion issued on November 7. Changes have been made to the following pages:

cover page—caption correction.

page 7, first full paragraph—clarification of figures

page 36, carryover paragraph—clarification of figures

page 43—phrase added to Conclusion.

JBJ/amb

cc: Counsel of Record
The Hon. Fred S. Silverman

IN THE SUPREME COURT
OF THE STATE OF DELAWARE

LEHMAN BROTHERS BANK, FSB,	§	No. 656, 2006
Appellant Below, Appellant,	§	Court Below: Superior Court of the State of Delaware in and for New Castle County
v.	§	
STATE BANK COMMISSIONER,	§	C.A. No. 05A-06-004
Appellee Below, Appellee.	§	

Submitted: May 23, 2007
Decided: November 7, 2007
Modified: November 9, 2007

Before **HOLLAND**, **JACOBS** and **RIDGELY**, Justices.

Upon Appeal from the Superior Court. **AFFIRMED IN PART, REVERSED IN PART and REMANDED.**

Stanford L. Stevenson, III and Anne Shea Gaza, Esquires, of Richards, Layton & Finger, Wilmington, Delaware; Of Counsel: Paul H. Frankel (argued) and Irwin M. Slomka, Esquires, of Morrison & Foerster, LLP, New York, New York; for Appellant.

Thomas P. McGonigle, Esquire, of Wolf, Block, Schorr and Solis-Cohen, LLP, Wilmington, Delaware; Of Counsel: Joseph C. Bright (argued) and Cheryl A.

Upham, Esquires, of Wolf, Block, Schorr and Solis-Cohen, LLP, Philadelphia, Pennsylvania; for Appellee.

JACOBS, Justice:

Appellant Lehman Brothers Bank, FSB appeals from a Superior Court Order[1] affirming a decision by the State Bank Commissioner (the "Commissioner")[2] assessing additional franchise tax and penalties against the Bank for the tax years 2000, 2001, 2002 and 2003. We affirm that portion of the Order upholding the imposition of additional franchise tax, reverse that portion upholding the assessment of penalties, and remand the case for further proceedings.

FACTS AND PROCEDURAL BACKGROUND

The material facts are undisputed. Since the 1980s, Lehman Brothers Holdings, Inc. ("LBH") has operated a mortgage business whose activities consist of acquiring, and earning interest on, mortgages issued by independent mortgage lenders and brokers or by LBH's subsidiary mortgage company, Aurora Loan Services, Inc. ("Aurora"). Before 1999, LBH's mortgage business was funded by unsecured bank

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[1] *Lehman Bros. Bank, FSB v. State Bank Commissioner*, 2006 WL 3457649 (Del. Super.) (cited herein as "Super. Ct. Op.").

[2] Decision of the Delaware State Bank Commissioner, dated May 20, 2005 (cited herein as "Comm. Dec."). Any references in this Opinion to the Commissioner are to the office of the Commissioner, not to the particular occupant of that office.

loans, commercial paper, or short and long-term repurchase agreements. Because this type of funding was unstable, LBH actively sought to acquire a federal savings bank, specifically to gain access to Federal Home Loan Bank ("FHLB") funding, which was a more stable and efficient funding source.

In 1999, LBH acquired Delaware Savings Bank, FSB, a federal savings bank organized under the Federal Home Owner's Loan Act, and subject to regulation and supervision by the United States Office of Thrift Supervision, and changed its name to Lehman Brothers Bank, FSB (the "Bank"). The Bank's federal stock charter, which became effective on June 30, 1999, designated Wilmington, Delaware as the Bank's "home office." That designation enabled the Bank to access FHLB funds from the Pittsburgh FHLB.

The Bank maintained a retail banking office—located in Wilmington, Delaware—for personal banking services. That retail operation was not profitable. The Bank's profitable operation was its mortgage banking business.[3] In that latter business, the Bank had two primary sources of funds for acquiring mortgages: (i) funds derived from sales of certificates of deposit (representing 25-30% of the total funds) and (ii) funds derived from FHLB loans (representing 50-60%

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[3] In addition to its retail and mortgage banking activities, the Bank conducted a trust services operation, beginning in 2002.

of the total). Using those funds, the Bank acquired mortgages in one of three ways: outright purchase,[4] direct origination,[5] and origination through a correspondent lender.[6] The Bank customarily held the mortgages for 45-60 days—a practice generating interest income that represented about 97% of the Bank's total income. After 45-60 days, the Bank then "sold" the mortgages to its parent company, LBH, making no profit on the transfer.

Most of the Bank's senior management was based in New York, and the Bank's board of directors met approximately eight times a year in New York. For the tax years in question, about 12 persons were employed at the Delaware home office. Half of the Delaware employees engaged in retail banking activities, and half performed accounting and other support services for the Bank as a whole. To conduct its mortgage banking business, the Bank employed 20-25 full-time direct employees in New York (all on the Bank's payroll), 66 "dual employees" in New York (persons on LBH's payroll, for whose services the Bank reimbursed LBH), and 24 "dual employees" in

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[4] The Bank bought residential mortgage pools that were already issued and funded.

[5] A borrower who wanted a mortgage would apply to Aurora, which would approve the borrower's credit and the mortgage under the Bank's guidelines. Aurora's services were usually performed in Colorado.

[6] Another lender would underwrite and fund the loan and would then sell the mortgage to the Bank, through Aurora.

Colorado (persons on Aurora's payroll, but for whose services the Bank reimbursed Aurora).

For each of the years at issue (2000-2003) the Bank filed a Delaware Franchise Tax Report. Delaware imposes a bank franchise tax on the taxable income of banking organizations for the privilege of doing business in this State.[7] The measure of the franchise tax depends importantly on whether the banking organization (here, a federal savings bank) is domiciled in Delaware.[8] Under 5 *Del. C.* § 1101(a) ("subsection (a)"), a federal savings bank with its "principal office" in Delaware is taxed on all its taxable income.[9] But, under line 4(b) of its Return, a bank may deduct from its reported income the portion that was earned from activities conducted outside Delaware by branches or subsidiaries subject to income taxation under the laws of another state (a "line 4(b) deduction").[10] Under 5 *Del. C.* § 1101(b) ("subsection (b)"), a federal savings bank not "headquartered" in Delaware is subject to a more limited bank franchise tax, imposed only on the income of the

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[7] *See* Super. Ct. Op. at *4.

[8] *See* 5 *Del. C.* § 1101.

[9] 5 *Del. C.* § 1101(a) and 5 *Del. C.* § 101(4)(b).

[10] Under Section 1101(a)(1)(b)(2), a Delaware bank with out-of-state branches and subsidiaries may reduce its "taxable income" by "[t]hat portion of the net operating income before taxes, verifiable by documentary evidence ... which is ... [d]erived from business activities carried on outside [Delaware] and subject to income taxation under the laws of another state."

bank's Delaware branches or subsidiaries, if any. The Delaware bank franchise tax statute does not define the terms "principal office" or "headquartered." For ease of reference, we sometimes refer to either of those terms, or both interchangeably, as "domicile," or "domiciled."

For the year 2000, the Bank filed its Franchise Tax Return under subsection (a), as had its predecessor (the Delaware Savings Bank), as a banking organization having its "principal office" in Delaware. For that tax year, the Bank reported all its income, but claimed a line 4(b) deduction to reflect its income from activities conducted outside Delaware, even though the Bank had no formally established out-of-state branches or subsidiaries. The Commissioner's office made no objection to the Bank's 2000 Franchise Tax Return for nearly three years.

The Bank used the same approach in filing its Franchise Tax Return for the tax year 2001. The Bank filed its 2001 Return (in 2002) under subsection (a), as a banking organization having its "principal office" in Delaware, and again claimed a line 4(b) deduction. Thereafter, the Commissioner contacted the Bank to discuss the Return. During those discussions, the Commissioner requested, among other things, documentation to support the line 4(b) deduction. The statute allowing that deduction authorizes the taxpayer to deduct "net operating income before taxes *verifiable by documentary evidence* from any

subsidiary or . . . branch."[11] In response to that request, the Bank submitted, in March 2003, two "apportionment schedules," consisting of one-page charts listing income purportedly allocated and reported to other states.

In 2003, the Bank filed its 2002 Franchise Tax Return, again under subsection (a), and again claiming a line 4(b) deduction. By letter dated October 6, 2003, the Commissioner advised the Bank that its Returns for the tax years 2000-2002 were incorrect, because (in the Commissioner's view) the Bank had no basis to claim a line 4(b) deduction. The Commissioner then recalculated the Bank's tax liability based on the disallowance of the line 4(b) deduction, and also assessed "late penalties." The Bank disputed both the assessment and the penalties. That dispute prompted the Commissioner to issue a notice of proceedings under 29 *Del. C.* § 10122 for purposes of finally determining the Bank's franchise tax liability for tax years 2000, 2001, and 2002.

In response to the Commissioner's disallowance of the line 4(b) deduction in its 2000-2002 Returns, the Bank did not claim that deduction in its 2003 Franchise Tax Return (filed in 2004). The Bank filed its 2003 Return under subsection (a)—as before—but instead of claiming a line 4(b) deduction, the Bank reported only that portion of its income it claimed to

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[11] 5 *Del. Admin. C.* § 1105, Item 4(b), based on 5 *Del. C.* § 1101(a)(1)(b)(2) (emphasis added).

be attributable to Delaware.[12] On August 2, 2004, the Commissioner issued a revised notice of proceedings, this time covering the Bank's franchise tax liability for all four years in question, *i.e.* 2000-2002 and 2003. An evidentiary hearing before the Commissioner was scheduled for September 30 and October 1, 2004.

After it received the Commissioner's August 2, 2004 notice, the Bank submitted amended Franchise Tax Returns for all four tax years. The basis for the amended Returns was that, for all the years at issue, the Bank was not domiciled in Delaware, contrary to what the Bank had represented in its original Returns. Therefore, the Bank should be taxed under subsection (b), only on the income earned from its Delaware operations. In submitting those amended Returns, the Bank reported that it used a separate accounting method, based on a study prepared by Ernst & Young, to segregate the income generated by the Bank's Delaware retail operations from the income generated by the Bank's "nationwide" mortgage and trust operations. Based on that accounting method, the Bank claimed that it was entitled to tax refunds for all four years, totaling approximately $14 million.

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[12] The income reported on the 2003 Franchise Tax Return was, therefore, significantly less than the amounts reported on the Tax Returns filed for the previous three years.

After the evidentiary hearing, the Commissioner determined that because the Bank was domiciled in Delaware, subsection (a) of Section 1101 was applicable. The Commissioner further decided that the Bank was not entitled to claim a line 4(b) deduction, because it had no out-of-state "branches" or "subsidiaries." Therefore, the Commissioner concluded that a franchise tax balance of $10.5 million was due, and assessed "late penalties" for each tax year, at a daily rate of 0.05% of the balance, to accrue at the same rate until the additional assessed tax was paid.[13] The "late penalties" imposed from March 1, 2001 (the due date for the 2000 tax) to May 20, 2005 (the date of the Commissioner's decision) totaled approximately $4 million.[14]

The Bank appealed to the Superior Court, which upheld the Commissioner's decision. The Superior Court held that: (i) the Bank was domiciled in Delaware for franchise tax purposes; (ii) all of the Bank's interest income was earned in, and derived from,

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[13] *See* Comm. Dec. pp. 17-21. The total assessment of $14,515,474 was divided as follows: (1) for 2000: $3,209,996 franchise tax assessed; $854,996 balance due; $658,778 penalty; (2) for 2001: $4,936,270 franchise tax assessed; $1,726,410 balance due; $1,015,123 penalty; (3) for 2002: $7,715,354 franchise tax assessed; $3,144,482 balance due; $1,275,087 penalty; and (4) for 2003: $11,577,586 franchise tax assessed; $4,777,586 balance due; $1,063,012 penalty.

[14] Because the Bank has not paid the additional tax assessed, the aggregate penalties have increased to approximately $7.8 million as of the date of oral argument before this Court.

Delaware; (iii) the Commissioner's method of assessing the tax did not violate the Commerce or the Due Process Clauses of the United States Constitution; and (iv) the Commissioner did not abuse its discretion by refusing to abate the tax assessment and the penalties.

This appeal followed.

THE CLAIMS OF ERROR: AN OVERVIEW

On appeal, the Bank advances several claims of error. The Bank first claims that the Commissioner and the Superior Court reversibly erred by concluding that the Bank was domiciled in Delaware and, thus, subject to Section 1101(a). The Bank takes the position that it was (and is) domiciled in New York, because most of the Bank's employees, including its senior management, work in New York. Therefore, the Bank claims, the applicable franchise tax provision is not Section 1101(a), but Section 1101(b), under which only the income attributable to a Delaware "branch" is subject to tax.

Second, and alternatively, the Bank argues that even if Section 1101(a) is the applicable statute, the Commissioner and the Superior Court reversibly erred in holding that the Bank was subject to Delaware bank franchise tax on 100% of its income. That was error, the Bank contends, because (i) the Bank did not earn all of its income in Delaware, and (ii) the statutorily prescribed manner of assessing the tax violates the Commerce and the Due Process Clauses.

Third, the Bank claims that the Superior Court reversibly erred in finding that the Commissioner properly refused to abate the penalties. Fourth, the Bank argues that if this Court finds that the Bank is entitled to a tax refund, the Bank is entitled to pre-judgment interest on that refund. These claims generate the issues presented on this appeal.

The first issue is whether the Bank is domiciled in Delaware. If the Bank is *not* domiciled in Delaware, then Section 1101(b) applies and the Bank's amended Franchise Tax Returns—filed under Section 1101(b)—were correct, thereby entitling the Bank to a tax refund. If, however, the Bank is domiciled in Delaware, then the Bank is subject to Section 1101(a), in which case the question becomes whether the Bank was entitled to a line 4(b) deduction. We conclude that the Bank was domiciled in Delaware, and that under the applicable statute—Section 1101(a)—the Bank was not entitled to apportion its income by taking a line 4(b) deduction.

The next set of issues involve whether the Delaware bank franchise tax statute violates the Commerce and/or the Due Process Clause. We hold that the apportionment mechanism contained in the Delaware statute (which is not available to the Bank in this case) passes constitutional muster under the Commerce and the Due Process Clauses.

The final issue is whether the Commissioner abused its discretion by refusing to abate the penalties assessed. We conclude that in these specific

circumstances the Commissioner abused its discretion by not abating the penalties and that the Superior Court erred in holding otherwise.

STANDARD OF REVIEW AND ANALYSIS OF THE CLAIMS OF ERROR

In reviewing an administrative agency's decision, this Court determines whether the factual findings of the agency are "supported by substantial evidence on the record before the agency."[15] Where, as here, the agency has interpreted and applied statutory provisions, those determinations involve questions of law[16] that this Court reviews *de novo*.[17]

Section 1101(a) Is Applicable Because The Bank Was Domiciled in Delaware

Section 1101(a) of the bank franchise tax statute applies to federal savings banks having their "principal office" in Delaware. Section 1101(b) applies to federal savings banks that are not "headquartered" in Delaware. From the structure of Section 1101, it is

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[15] *Public Water Supply Co. v. DiPasquale,* 735 A.2d 378, 380-81 (Del. 1999) (citing *Stoltz Mgmt. Co., Inc. v. Consumer Affairs Bd.,* 616 A.2d 1205, 1208 (Del. 1992)).

[16] *Hubbard v. Hibbard Brown & Co.,* 633 A.2d 345, 349 (Del. 1993); *Bd. of Educ. of Smyrna School Dist. v. DiNunzio,* 602 A.2d 85, 92-93 (Del. 1990); *Public Water,* 735 A.2d at 380-81.

[17] *Del. Bay Surgical Serv., P.C. v. Swier,* 900 A.2d 646, 652 (Del. 2006) (citing *Coastal Barge Corp. v. Coastal Zone Ind. Control Bd.,* 492 A.2d 1242, 1246 (Del. 1985)).

evident that the terms "principal office" and "headquarter[s]" are used interchangeably.[18] Neither term is defined in Chapter 5 (Banking) of the Delaware Code, of which Section 1101 is a part. This Court must therefore ascertain the meaning of those terms, which requires us to interpret the Delaware bank franchise tax statute, as applied to a federal savings bank.

The Bank argues that in interpreting the statute, the terms "principal office" and "headquarter[s]" must be given their ordinary meaning. According to the Bank, the ordinary meaning is "commercial domicile," defined as "the place from which the trade or business is principally managed or directed."[19] Under that definition the Bank's "commercial domicile" would be New York, because the Bank's executive officers are employed in New York, its board of

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[18] *See Chrysler Corp. v. State,* 163 A.2d 239, 241 (Del. 1960) (holding that where similar terms are used in different subsections of the same provision, those terms should be construed to have the same meaning). The Report on "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories" of the United States Advisory Commission on Intergovernmental Relations, dated May 1975 (the "ACIR Report") recognizes that the terms "domicile," "principal office," "home office," and "headquarters" are synonymous. *See* ACIR Report, p. 53.

[19] The "ordinary meaning" definitions suggested by the Bank are extracted either from dictionaries or from regulations that are not applicable in Delaware: the Uniform Division of Income for Tax Purposes Act (UDITPA) and a Model Statute adopted by the Multistate Tax Commission (MTC). Delaware has not adopted the UDITPA and is not a member of the MTC.

directors meets exclusively in New York, its regulatory examinations are conducted in New York, and most of its mortgage-related decisions are made in New York.

We disagree with the Bank's interpretation. The rule of construction which requires that an undefined statutory term be given its ordinary meaning does not apply to terms of art. Under the general rules of statutory interpretation set forth in the Delaware Code, "technical words and phrases . . . [must] be construed and understood according to [their] peculiar and appropriate meaning."[20] Here, the terms "principal office" and "headquarter[s]" are terms of art and, therefore, must be given their "peculiar and appropriate meaning." Because those terms are used in a statute imposing a tax upon "banking organizations"—entities that include federal savings banks—we conclude that the appropriate meaning of "principal office" and "headquarter[s]" is the meaning accorded those terms by the regulations that govern federal savings banks and their taxation.

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[20] 1 *Del. C.* § 303. *See also Shell Petroleum, Inc. v. U.S.*, 182 F.3d 212, 217-18 (3rd Cir. 1999) (citing *Corning Glass Works v. Brennan*, 417 U.S. 188, 202 (1974)).

The Code of Federal Regulations (CFR)[21] requires that all federal savings banks designate a "home office."[22] Under the CFR, "home office" is synonymous with "principal office." The latter term is employed in Section 1101 of the Delaware statute.[23] Here, the Bank's federal stock charter explicitly designates Wilmington, Delaware as the "home office." The CFR further mandates that if a federal bank wishes to change its home office address, it must apply to the United States Office of Thrift Supervision ("OTS").[24] The Bank has never applied to the OTS to change the location of its Wilmington, Delaware home office. Therefore, under the CFR, the Bank is domiciled in Delaware.

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[21] This Court has used federal definitions when a Delaware tax statute did not clearly define a term. *See Director of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003). Several provisions in Chapter 30 (Taxation) of the Delaware Code actually require that certain statutory terms be given the same meaning as when used in federal laws. *See, e.g.*, 30 *Del. C.* § 502(a), § 1101, § 2071. *See also Gow v. Director of Revenue*, 556 A.2d 190, 193 (Del. 1989).

[22] *See* 12 C.F.R. § 545.91(a) which provides that "[a]ll operations of a Federal savings association are subject to direction from the home office."

[23] *See* 12 C.F.R. § 561.39 ("The term principal office means the home office of a savings association established as such in conformity with the laws under which the savings association is organized.") *See also* 12 C.F.R. § 925.18(b) ("the principal place of business . . . is the state in which the institution maintains its home office.")

[24] *See* 12 C.F.R. § 545.91(b).

Other applicable regulations lead to the same conclusion. 12 U.S.C. § 1424(b) prescribes that a federal savings bank "may become a member *only* of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's *principal place of business.*"[25] Here, the Bank borrowed exclusively from the FHLB in Pittsburgh, which serves Delaware—but not New York—federal savings banks. We regard this course of conduct as evidence that the Bank considered its "principal place of business" to be Delaware, not New York.

The Delaware bank franchise tax statute also points to the conclusion that the Bank is domiciled in Delaware. Although that statute does not define "principal office" and "headquarter[s]," it does define a similar term—"located"—that appears in *both* subsections of Section 1101.[26] Under 5 *Del. C.* § 831(8), a savings institution is "located" in "the state in which the amount of aggregate deposits of all its offices in that state is greatest."[27] The Bank had

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[25] 12 U.S.C. § 1424(b) (emphasis added).

[26] Section 1101 cross-references Section 801(5) for the definition of the word "located." Section 801(5) provides that a bank is "located" in Delaware if the "organization certificate identifies an address in [Delaware] as the place at which its discount and deposit operations are to be carried out." That definition is applicable to state-chartered banks and national banks. However, a similar definition, specifically applicable to savings institutions, is contained in Section 831(8).

[27] 5 *Del. C.* § 831(8).

only one office where its deposit operations were conducted. That office was located in Delaware.

Finally, we note a recent amendment to the Delaware bank franchise law that defines, for the first time, the term "headquarters." Under the new provision, the "headquarters" of a national banking association are located "in the state of the bank's *home office* as designated in its charter."[28] Although that amendment is effective for tax years post-2006 (and, thus, not applicable here), the definition it adopts is instructive and fully supports the interpretation reached here.[29]

For these reasons, we conclude that both the Commissioner and the Superior Court correctly held that the Bank was domiciled in Delaware for franchise tax purposes. As a consequence, Section 1101(a) was the applicable provision for computing the Delaware bank franchise tax.

The Bank Is Not Entitled To A Line 4(b) Deduction Under Section 1101(a)

Under Section 1101(a), the entire net income of federal savings bank domiciled in Delaware is taxed

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[28] *See* 5 *Del. C.* § 1101A(c)(9) (emphasis added). National banks are subject to regulations which are very similar to those governing federal savings banks.

[29] *See Chrysler Corp. v. State,* 163 A.2d 239, 241 (Del. 1960) ("A change in the phraseology of the amendment creates a presumption that the Legislature intended a change of meaning.")

by Delaware, unless that entity has an out-of-state "branch" or "subsidiary." In that case, the income attributable to the branch or subsidiary may be deducted from the total reported income, subject to certain limitations. For a line 4(b) deduction to be available, however, the income sought to be excluded must be: (a) derived from business activities carried in other states through "branches" or "subsidiaries," (b) "verifiable by documentary evidence," and (c) subject to income taxation under the laws of another state.[30] The Superior Court and the Commissioner held that the Bank did not satisfy these conditions. We uphold their determination.

Regarding the first condition, it is undisputed that the OTS must approve the establishment of "branches" and "subsidiaries,"[31] and that during the years in question the Bank had no OTS-approved branches or subsidiaries.[32] The Bank requested OTS' approval to open a branch in New Jersey (to be effective January 2004), but it never sought OTS' approval to establish a New York branch. Rather, the Bank applied only for approval of an "agency office" in New York, "solely to conduct trust activities." The

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[30] *See* 5 *Del. C.* § 1101(a); 5 *Del. Admin. C.* § 1105, Item 4(b).

[31] *See* 12 C.F.R. §§ 545.93(a), 559.3 and 559.11.

[32] Until January 2004, the Bank had no out-of-state branches, and its only Delaware branch closed in December 2000. On August 6, 2003, the Bank applied to the OTS for approval to open a branch in New Jersey, which was granted, effective January 26, 2004. *See* Comm. Dec., p. 6.

distinction is significant, because "agency offices" are expressly excluded from the CFR definition of "branch."[33]

The Bank asserts, nonetheless, that for franchise tax purposes it had *de facto* branches in the other states to which it "paid more than $106 million in state and local income taxes."[34] This argument has no legal force. Congress has decreed that any "branches" must be approved by the OTS. That requirement reflects a policy judgment that a branch is more than a verbal label—it is a geographical location where a monopoly activity may be lawfully conducted.[35] Because approval of a branch authorizes the taking of deposits and the making of loans by the branch exclusively at that particular location, there is no such thing as a *de facto* branch in the federally regulated banking industry.

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[33] "Any office *other than* [the] home office, *agency office*, administrative office, data processing office, or an electronic means or facility." *See* 12 C.F.R. § 545.92(a) (emphasis added).

[34] This assertion is based on a report prepared by PricewaterhouseCoopers, which contains a one-page chart listing other states where the Bank paid taxes during the years at issue (*e.g.* New York, California and Colorado) and the amounts paid in each state.

[35] Delaware regulations similarly make the opening of a branch by a state bank subject to the State Bank Commissioner's approval. A branch is defined as "any location . . . at which deposits are received or checks paid or money lent." *See* 5 *Del. C.* § 770(a)(1).

Faced with this insurmountable legal obstacle, the Bank attempts to circumvent it by arguing that requiring a taxpayer bank to establish a formal branch to avail itself of the line 4(b) deduction "does not reflect modern banking practices." Under such "modern practices," the Bank asserts, certain mortgage banking related activities may be conducted without prior OTS approval, through an out-of-state "agency office." It is the case that federal savings banks are allowed, under federal law, to conduct limited activities through agency offices without OTS approval.[36] Even so, this limited exception does not aid the Bank's position, because the Delaware bank franchise tax statute permits a line 4(b) deduction only on income earned by an out-of-state "branch" or "subsidiary," and, under federal law, an "agency office" is not a "branch." Accordingly, the Commissioner properly held that the absence of any OTS-approved branches or subsidiaries precludes the Bank from taking advantage of the line 4(b) deduction.

Even if we accepted the Bank's argument that an OTS-approved branch was not required to enable the Bank to take a line 4(b) deduction, other conditions for utilizing that deduction remain unsatisfied. First, the Bank failed to provide (either at the time of filing or after) "documentary evidence" verifying that the

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[36] *See* 12 C.F.R. § 545.96. Those activities are limited to "[s]ervicing, originating, or approving loans and contracts" and "managing or selling real estate."

portion of the income it sought to exclude from the taxable income reported in Delaware was "derived from business activities carried in other States."[37] The only documents furnished by the Bank were "apportionment schedules" that listed the percentages of the Bank's total income that were "allocated" to other states. Those schedules did not explain how those percentages were calculated, and, moreover, covered only tax years 2000 and 2002, even though the Bank also claimed the line 4(b) deduction for tax year 2001. As the Superior Court noted, the Bank should have prepared "a separate Delaware balance sheet accounting for the money earned in Delaware."[38] Second, the Bank failed to prove that other states were taxing the line 4(b) deducted income. As the Superior Court found, the Bank did not establish whether the other states "taxed the same mortgage interest income, or if they taxed other transactions, such as an origination fee or transfer fee."[39]

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[37] 5 *Del. C.* § 1101(a)(1)(b)(2); 5 *Del. Admin. C.* § 1105, Item 4(b).

[38] Super. Ct. Op., at *7.

[39] Super. Ct. Op., at *7. The only evidence produced by the Bank is the one-page chart included in the Pricewaterhouse-Coopers report confirming the accuracy of Ernst & Young's analysis regarding the separate accounting method used in the amended Franchise Tax Returns.

The Bank Is Not Entitled To Any Other Apportionment

Having determined that the Bank was not entitled "to account for its out-of-state operations" by taking a line 4(b) deduction, we must decide whether the Bank was allowed to apportion its income in some different manner. The Bank claims that, to the extent the Delaware statute does not allow apportionment, the United States Constitution requires that result. Specifically, the Bank argues that the Commissioner and the Superior Court reversibly erred in holding that Delaware could tax 100% of the Bank's income because (i) in fact, the Bank did not earn all of its income in Delaware, and (ii) the tax assessed on that counterfactual basis violates the Commerce and the Due Process Clauses.

We initially dispose of the Bank's first argument. The Bank goes to great pains to argue that the activities which generated its mortgage-related funding and income "all took place outside Delaware, principally in New York." Both the Superior Court and the Commissioner determined, however, that "all [the Bank's] income was actually earned in and derived from sources in Delaware."[40] Under Delaware's taxation scheme, the *entire* net income of a federal savings bank having its home office in Delaware is taxed by Delaware, except for income attributable to out-of-state branches or subsidiaries. Under that scheme,

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[40] Super. Ct. Op., at *6.

where the Bank's income was *in fact* earned is not a relevant inquiry, because the statute authorizes Delaware to tax the Bank's entire income.[41] To say it differently, to resolve the constitutional issues we need not determine what portion of the income was in fact earned in Delaware and what portion, if any, was in fact earned elsewhere.[42] Rather, the inquiry is whether Delaware's taxation scheme "reasonably" reflects the in-state component of the activity being taxed[43] (under the Commerce Clause) and whether there is a "rational" relationship between the taxed income and the values connected with the taxing state[44] (under the Due Process Clause). For the

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[41] *See* 5 *Del. C.* § 1101(a). Delaware's statutory scheme is in line with the recommendations of the ACIR Report on "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories" that where a financial depository is subject to franchise tax in more than one state, "*the domiciliary State* (ordinarily the State of the principal, headquarters, or home office) *may apply its tax on the entire income* . . . , but shall allow . . . a credit against such tax liability for similar taxes paid to other States." *See* ACIR Report, p. 53 (emphasis added).

[42] In *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 273 (1978), the United States Supreme Court noted that most apportionment formulas are imprecise and "will occasionally over-reflect or under-reflect income attributable to the taxing State."

[43] *Goldberg v. Sweet,* 488 U.S. 252, 262 (1989). *See also Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159, 169 (1983) (holding that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated").

[44] *Moorman,* 437 U.S. at 273 (1978) (citing *Norfolk & Western R. Co. v. State Tax Comm'n,* 390 U.S. 317, 325 (1968)). *See also Quill Corp. v. North Dakota,* 504 U.S. 298, 305-06

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reasons next discussed, we conclude that Delaware's bank franchise tax statute passes muster under both constitutional provisions.

A. *Commerce Clause Analysis*

The Commerce Clause authorizes Congress to "regulate Commerce . . . among the several States."[45] Although the Commerce Clause is expressed as an "affirmative grant of power," the United States Supreme Court has consistently held that the Commerce Clause also contains a negative implication, known as the Dormant Commerce Clause, which prohibits certain state actions that interfere with interstate commerce.[46]

A taxpayer challenging a state taxation statute carries the burden of overcoming the presumption of constitutionality with clear and convincing evidence.[47] To determine a statute's constitutionality under the

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(1992) (quoting *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-45, (1954)).

[45] U.S. Const. Art. I, § 8, cl. 3.

[46] *See, e.g., Oklahoma Tax Comm'n v. Jefferson Lines, Inc.,* 514 U.S. 175, 179-80 (1995); *Quill Corp. v. North Dakota,* 504 U.S. 298, 309 (1992); *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 458 (1959).

[47] *See Atlantis J Condo. Ass'n v. Bryson,* 403 A.2d 711, 714 (Del. 1979); *Justice v. Gatchell,* 325 A.2d 97, 102 (Del. 1974). In particular, a strong presumption of validity exists for the state taxing statutes. *See Kunkel's Estate v. U.S.,* 689 F.2d 408, 424 (3rd Cir. 1982). *See also Estate of Kunze v. C.I.R.,* 233 F.3d 948, 954 (7th Cir. 2000).

Dormant Commerce Clause, the United States Supreme Court has consistently applied the *Complete Auto Transit, Inc. v. Brady*[48] test. Under that test, a tax will be upheld if: (1) it is applied to an activity having a substantial nexus to the taxing state, (2) it is fairly apportioned, (3) it does not discriminate against interstate commerce, and (4) it is fairly related to the services provided by the taxing state.[49] The Bank's Commerce Clause claim is limited to the second prong of *Complete Auto.*[50]

Specifically, the Bank argues that the Delaware bank franchise tax is not fairly apportioned, because the statute does not allow a federal savings bank that is domiciled in Delaware and has no out-of-state branches to apportion its income to account for income-generating operations conducted in other states. The Commissioner responds that the *Complete Auto* test, and its fair apportionment requirement, are inapplicable in this case. Therefore, we must first address a threshold issue: whether *Complete Auto* is applicable at all. We conclude that it is.

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[48] 430 U.S. 274 (1977).

[49] *See Complete Auto,* 430 U.S. at 279.

[50] The Bank does not dispute that the tax complies with *Complete Auto's* other three requirements. However, the Superior Court analyzed in detail all four prongs and concluded that each of them was satisfied. *See* Super. Ct. Op., at *9-10.

1) *Complete Auto Is Applicable*

The Commissioner contends that the *Complete Auto* test established to implement the Dormant Commerce Clause does not apply here, for two reasons. First, the Commissioner argues, Congress affirmatively exercised its power to regulate interstate commerce in this area by enacting Section 1464(h) of the Federal Home Owner's Loan Act (HOLA). Therefore, the Commerce Clause is not "dormant" and may not be used as a basis to attack the constitutionality of a Delaware statute adopted under the authority affirmatively delegated by the Congress to the states in Section 1464(h) of HOLA.

We conclude that the Dormant Commerce Clause is applicable. Section 1464(h) authorizes states to tax federal savings associations, but provides that such state taxes may not be "greater than that imposed . . . on other similar local mutual or cooperative thrift and home financing institutions."[51] That is, Congress affirmatively exercised its power to regulate the interstate commerce only in a limited way, *i.e.* to prohibit discriminatory state taxation of federal savings associations. Congress did not, however, affirmatively legislate to regulate any other aspect of state taxation of federal savings associations. As the United States Supreme Court has held, "federal regulation of a field of commerce should not be deemed preemptive of state regulatory power in the

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[51] *See* 12 U.S. Code § 1464(h), enacted in 1933.

absence of persuasive reasons—either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained."[52] Here, there is no "unmistakable" evidence that Congress intended affirmatively to regulate the entire field[53] of state taxation of federal savings banks. Therefore, Section 1646(h) of HOLA does not displace the Dormant Commerce Clause.

Second and alternatively, the Commissioner argues that even if the Dormant Commerce Clause applies *Complete Auto*'s requirement of fair apportionment is limited to non-domiciliaries. Therefore, Delaware domiciliaries such as the Bank may be taxed without any apportionment restrictions. Stated differently, the Commissioner urges that "a state has the constitutional power to tax all of the income of its residents, no matter where that income is earned."[54]

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[52] *Florida Lime & Avocado Growers, Inc. v. Paul,* 373 U.S. 132, 142 (1963).

[53] *See Southern Railway Co. v. D.L. Reid et al.,* 222 U.S. 424 (1912); *Lemke v. Farmers' Grain Co. of Embden,* 42 S. Ct. 244 (1922).

[54] Comm. Dec., at p. 15, citing *Oklahoma Tax Comm'n v. Chicksaw Nation,* 515 U.S. 450, 462-63 (1995); *New York ex rel. Cohn v. Graves,* 300 U.S. 308, 313 (1937); *Lawrence v. State Tax Comm'n,* 286 U.S. 276 (1932); *Chase Manhattan Bank v. Gavin,* 733 A.2d 782 (Conn. 1999). Those cases dealt with various taxes imposed upon pure "locals" (either resident *individuals* or domestic *corporations*) whereas here we must determine whether a specific tax (the bank franchise tax) is applicable to a specific entity (a *federal savings bank* with its "home office" in Delaware but conducting multi-state operations).

The United States Supreme Court has not yet decided whether a state may constitutionally tax the *unapportioned* net income of a domiciliary entity that derives income from other states in which it conducts business. This issue was addressed, however, by the Supreme Court of Rhode Island in *Commercial Credit Consumer Services, Inc. v. Norberg.*[55] That case (*Commercial Credit*) involved a tax similar to the one at issue here, on banking institutions organized or incorporated under the laws of Rhode Island (the taxing state). The tax was computed on "net income" from any sources. The Rhode Island statute allowed no apportionment, but permitted the domiciliary to deduct its ordinary and necessary expenses of doing business from "gross income." Those deductible expenses included taxes paid to other states in which the domiciliary conducted business. Underscoring the novelty of the issue, the Rhode Island Supreme Court held that "modern doctrine . . . appears to permit, either under the commerce clause or the due process clause, a state to tax [local] *businesses engaged in interstate commerce* so long as the tax is applied to an activity that bears a substantial nexus to the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state", *i.e.* the *Complete Auto* requirements.[56] After conducting a *Complete*

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[55] 518 A.2d 1336, 1337 (R.I. 1986).

[56] *Id.* (citing *Complete Auto,* 430 U.S. at 279) (emphasis added).

Auto analysis, the Court concluded that the Rhode Island tax satisfied the Commerce Clause.[57] The Court emphasized that it was a net-income tax[58] (as opposed to a gross receipts tax), that the statute allowed for deduction of taxes paid in other states, and that the taxpayer entity had failed to clearly show what taxes had been levied by other states.

Although the *Commercial Credit* case is not binding on us, we regard its conclusion—that *Complete Auto* is the appropriate analytical framework—as highly persuasive. Here, like in *Commercial Credit,* the Bank, although domiciled in the taxing state and having no out-of-state branches or subsidiaries, was nevertheless "engaged in interstate commerce."[59] By parity of reasoning, we conclude that the

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[57] Contrary to what the Bank argues, it is irrelevant that Rhode Island amended its relevant statute in 1995 to permit banks to apportion their income. *See People v. Regelin,* 443 N.W.2d 436, 438 (C.A. Mich. 1989). Moreover, the *Commercial Credit* ruling (*i.e.* that if the *Complete Auto* requirements are met, a State may tax the entire net income of a domestic entity which conducts all or some of its business out-of-state) was implicitly endorsed in *District of Columbia v. Chase Manhattan Bank,* 689 A.2d 539, 542-43 (D.C. App. 1997).

[58] *See United States Glue Co. v. Oak Creek,* 247 U.S. 321 (1918) (distinguishing between a tax upon gross receipts—more likely to impede or discourage the conduct of commerce—and a tax upon the net income, arising from whatever source, which would be constitutional if there is no discrimination against interstate commerce).

[59] The purpose of the Commerce Clause is not "to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the

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Complete Auto test controls the Commerce Clause analysis.

2) *Complete Auto's Fair Apportionment Requirement Is Satisfied*

We now reach the Bank's claim that the second prong of *Complete Auto* is not satisfied, because under the Delaware statute the tax is not fairly apportioned. The applicable Delaware bank franchise tax has a two-fold "structural" apportionment mechanism. First, a bank domiciled in Delaware would not be taxed on income attributable to (OTS-authorized) out-of-state branches or subsidiaries, to the extent that other states tax that portion of the income. Second, a bank not domiciled in Delaware would be taxed only on the income attributable to a Delaware branch or subsidiary.

The Bank first contends that, by amending the statute in 2006, the Delaware Legislature "recognized the constitutional infirmities of the existing regime." Under the 2006 amendment, a bank may choose to be taxed under the Section 1101 method (as occurred here) or under an alternative method established in Section 1101(A) (which was not available to the Bank for the tax years at issue). The alternative franchise tax is the sum of two components: (1) a tax on the

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business." *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 182-83 (1995) (citing *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

"entire net income" that is apportioned to the state of Delaware, and (2) a location benefit tax "reflecting the value of utilizing Delaware's banking laws and bank system." The three factors used for apportionment are property, payroll, and receipts.[60]

We find no merit to the Bank's contention that the 2006 amendment exposes the constitutional infirmity of the pre-amendment scheme. Absent legislative history showing the contrary, a statutory amendment will not be regarded as indicative that the predecessor version was unconstitutional.[61] Here, the legislative history indicates that the purpose of the amendment was "to promote economic development"[62] in Delaware. There is no evidence of any purpose to correct any perceived unconstitutionality of the original version.

Under *Complete Auto's* second prong, a tax is fairly apportioned if it is internally and externally consistent.[63] Nowhere in its briefs does the Bank dispute that the internal consistency test is met. The

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[60] *See* 5 *Del. C.* § 1101(A).

[61] *See People v. Regelin,* 443 N.W.2d 436, 438 (C.A. Mich. 1989), where the court found that "reliance on the amendment [of a criminal statute] to support a conclusion that the Legislature recognized a constitutional infirmity in the existing statute" was "arguable."

[62] *See* Synopsis of S.B. 249, 143rd Gen. Assem. (Del. 2006).

[63] *See Container Corp. of Am. v. Franchise Tax Board,* 463 U.S. 159, 169 (1983); *Goldberg v. Sweet,* 488 U.S. 252, 261 (1989).

Superior Court held that the internal consistency test was satisfied because "[i]f every state's franchise tax included mortgage interest only when its banks held the mortgages, there would not be multiple taxation."[64] The Bank does not challenge this determination on appeal.

What the Bank claims is that the tax, as imposed, was not "externally consistent" because it was unapportioned and resulted in multiple taxation. The focus of the external consistency inquiry is upon the economic justification for the state's claim upon the value taxed.[65] That inquiry is whether the "factors used in the apportionment formula . . . actually reflect a reasonable sense of how income is generated."[66] The Bank cites no cases addressing an apportionment system that is similar to that employed by the Delaware statute. The federal cases cited by the Bank[67] merely reiterate the undisputed and well-settled proposition that external consistency mandates that states tax "only that portion of the

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[64] Super. Ct. Op., at *9.

[65] *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[66] *Container Corp.*, 463 U.S. at 169.

[67] *City of Modesto v. National Med., Inc.*, 128 Cal. App. 4th 518 (2005); *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108. 134 (Pa. 2003); *Southern Pacific Transp. Co. Inc. v. State, Dept. of Revenue*, 44 P.3d 1006 (Ariz. Ct. App. 2002); *City of Winchester v. Am. Woodmark Corp.*, 471 S.E.2d 495, 498 (Va. 1996). Those cases analyze various (different) systems of apportionment, or lack thereof.

revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[68]

Delaware's apportionment system is "structural." That is, the bank franchise tax statute apportions income according to the banking entity's structure: home office, branches, and subsidiaries. Structural apportionment is peculiarly tailored to banks, which are heavily regulated entities. The activities that a bank may conduct are restricted, the places (branches, subsidiaries, agency offices) where a bank may conduct those activities are specified, and both are subject to a detailed system of regulatory accounting and financial control. The Bank argues that Delaware's structural apportionment system is flawed because the only permissible apportionment factor is the source of the income (*i.e.*, where the income was earned), not how the entity is structured or how the income is earned. None of Bank's cited authorities supports its proposition.[69] Apart from the

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[68] *Goldberg v. Sweet,* 488 U.S. 252, 261 (1989).

[69] The typical apportionment formula used in most states combines three factors: tangible property, payroll and sales. We observe that "tangible property" is an asset, "payroll" is an expense, and only the "sales" factor represents income (more precisely, gross income). If (as the Bank argues) only income—and its source—is an appropriate apportionment factor, then it seemingly follows that the apportionment formula employed by most states is unconstitutional. However, the United States Supreme Court has specifically approved the classical apportionment formula. *See Container Corp.* and *Barclays Bank PLC v. Franchise Tax Bd. of Cal.,* 512 U.S. 298 (1994).

requirement of reasonableness, the United States Supreme Court has expressly declined to impose constitutional constraints on a state's selection of a particular income allocation formula.[70] As the Commissioner observed, states have "wide latitude" in devising constitutionally sufficient methods of fairly apportioning the income.[71] Delaware's system need not be the only method of apportioning income, nor need it be the "best" method in the view of any particular taxpayer. The Constitution does not require that Delaware conform to the prevailing approach adopted by other states.[72] All that is required is that the system chosen be reasonable. In our view, that requirement is met here.

Taxing the Bank's entire net income "reasonably reflects the in-state component" of its activity, namely, that the funds generated by the Bank's domiciliation in Delaware "fueled [LBH's] entire

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[70] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978) (upholding a single-factor formula).

[71] Comm. Dec., at p. 14.

[72] In *Container Corp.* and *Barclays Bank*, the United States Supreme Court analyzed California's franchise tax, applied on an entity's "worldwide combined income." The plaintiffs claimed that a "separate accounting" method of apportionment—treating each corporate entity of a multi-state corporation separately for the tax purposes—should be employed rather than the three-factor apportionment classical formula. The Supreme Court upheld the classical formula, noting that California was not required no give up the allocation method chosen, where both methods presented "inescapable imprecision" and both "sometimes result[ed] in double taxation."

mortgage banking business."[73] To acquire mortgages, the Bank had two primary funding sources: money generated by certificates of deposit sales and FHLB loans. The Bank held the mortgages purchased with those funds for 45 to 60 days, and the interest accumulated during that period generated almost 100% of the Bank's income.[74] The bank franchise tax is directed to that interest income, and only to that income. As the Superior Court correctly observed, "*Delaware did not tax any other transactions.* It did not tax the Bank's activities outside Delaware, such as Aurora's lending in Colorado. Nor did [Delaware] tax the loans and the interest income after they were moved from Delaware to New York."[75]

With respect to the first source of funding (certificates of deposit), LBH would not have had access to it without the Bank. Only a bank may accept deposits and issue certificates of deposit; therefore, the deposits were accepted at the Bank and the certificates were issued in the Bank's name. These operations all took place in Delaware. Attributing income generated by deposits to the place where a

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[73] Super. Ct. Op., at *9. After LBH acquired the Bank, up to 90% of the funds for LBH's mortgage business came from the Bank. *See* Super. Ct. Op., at *2.

[74] As one representative of the Bank testified "[W]e sent the money to Delaware because that's where . . . our operating account was. . . . [I]t has to hit the books and records somewhere. It can't really hit your books and records in New York. It has to hit your books and records in the bank."

[75] Super. Ct. Op., at *9 (emphasis added).

bank has its franchise to operate and is the only location at which deposits are accepted, is reasonable. The Bank's home office was in Wilmington, Delaware. The Bank's sole retail banking office, where all deposits were received, was established and staffed in Wilmington, Delaware. That the Bank had officers and employees at locations other than Wilmington does not weaken Delaware's "reasonable" economic justification for imposing the tax.

Regarding the second source of funding, only the Bank, not LBH, could (and did) receive FHLB loans. By virtue of being a Delaware-based federal savings association, the Bank was able to obtain loans from the Pittsburgh FHLB.

The Bank disputes this conclusion, arguing that LBH would have had access to federally insured deposits and FHLB loans (from Pittsburgh or elsewhere) if it acquired *any* federal savings bank, not necessarily one chartered in Delaware. But, LBH chose to acquire a Delaware bank, and that choice resulted in significant benefits: authorization to lend money outside the state in accordance with Delaware laws without regard to the other states' lending restrictions or usury laws; fire and police protection; access to courts; and access to schools, health care, and welfare benefits for the Bank's employees.[76] Those benefits are "reasonably" related to the Bank's presence in Delaware.

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[76] *See* Super. Ct. Op., at *10.

The Bank next urges that the external consistency test is not satisfied because the Delaware bank franchise tax creates both threatened and actual multiple taxation. There is no constitutional prohibition against actual double taxation occasioned by two states having different apportionment systems.[77] In any event, the Bank's argument leads nowhere because the Superior Court found that the Bank had failed to prove by "clear and cogent evidence"[78] precisely what income (if any) was taxed by other states. As earlier explained, other than an unsupported one page document purporting to show that $106 million in tax was paid to other jurisdictions, nothing in the record establishes actual multiple taxation or a significant threat thereof. Thus, the external consistency requirement is met here, because the structural apportionment framework of the Delaware bank franchise tax statute reasonably reflects and fairly measures the Delaware components of the Bank's "multi-state" business. Accordingly, Delaware's bank franchise tax does not violate the Dormant Commerce Clause.

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[77] *See Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 277-78 (1978); *Barclays Bank,* 512 U.S. at 318-19 (citing *Container Corp.,* 463 U.S. at 187-89).

[78] *Moorman Mfg.,* 437 U.S. at 274 (1978) ("assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that State,' or has 'led to a grossly distorted result.'") (internal citations omitted).

B. Due Process Clause Analysis

The Bank also challenges the constitutionality of the Delaware bank franchise tax statute under the Due Process Clause of the Fourteenth Amendment. For a state to constitutionally tax income generated in interstate commerce, the Due Process Clause imposes two requirements: "a 'minimal connection' or 'nexus' between the interstate activities and the taxing state, and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise.'"[79] The Bank argues that Delaware's taxing of all the Bank's income violates Due Process because no rational relationship exists between the tax imposed by Delaware and the income taxed, which, the Bank urges, was earned from activities conducted outside of Delaware.

The United States Supreme Court has held that the requisite nexus between the interstate activities and the taxing state is established if the taxpayer avails itself of the "substantial privilege of carrying on business" within the taxing state.[80] Sufficient connection has been found to exist where the taxpayer maintains an office in the taxing state.[81] Here,

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[79] *Container Corp.*, 463 U.S. at 169 (citing *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 436 (1980)).

[80] *Mobil Oil Corp.*, 445 U.S. at 436 (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444-45 (1940)).

[81] *D.H. Holmes, Ltd. v. McNamara*, 486 U.S. 24, 32 (1988); *Nat'l Geographic v. Cal. Equalization Bd.*, 430 U.S. 551, 556 (1977). Despite their similar language, the nexus requirements

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it is undisputed that the Bank had the requisite minimum contacts with Delaware: the Bank's home office and the Bank's sole banking office were both located in Wilmington, Delaware. Those contacts are sufficient to satisfy the Due Process minimal connection requirement.

For the second requirement to be satisfied, there must be a rational relationship between the taxed income and the "values connected with the taxing State."[82] The inquiry is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state."[83] The privilege of carrying on a business in the state; police and fire protection; emergency health services; public utilities; and a safe climate to conduct business have been deemed sufficient to support imposition of the tax.[84] The Superior Court held that "the Bank receives many of Delaware's benefits and protection,

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of the Due Process and Commerce Clauses are not identical. The Commerce Clause is more stringent than the Due Process Clause on the state's taxation power. *See Quill Corp. v. North Dakota,* 504 U.S. 298, 312-13 (1992). *See also J.C. Penney Nat. Bank v. Johnson,* 19 S.W.3d 831, 836-37 (1999).

[82] *Moorman Mfg.,* 437 U.S. at 272-73 (citing *Norfolk & Western R. Co. v. State Tax Comm'n,* 390 U.S. 317, 325 (1968)).

[83] *J.C. Penney,* 311 U.S. at 444.

[84] *See J.C. Penney,* 311 U.S. at 444; *Bridges v. Autozone Properties, Inc.,* 900 So.2d 784, 809 (La. 2005); *Zelinsky v. Tax Appeals Tribunal of State,* 801 N.E.2d 840, 848 (N.Y. 2003).

thus satisfying this requirement."[85] The record discloses no basis to disturb that finding.

For these reasons, the Commissioner and the Superior Court correctly concluded that the Delaware bank franchise tax, as applied to the Bank, satisfies the Due Process requirements imposed by the United States Constitution.

Abatement of Penalties

Finally, the Bank claims that the Commissioner erred by refusing to abate the assessed penalties, which, according to the Bank, totaled $14 million and were "excessive compared to the activities conducted in the State." Before reaching the issue of excessiveness, we note that the Bank's computation of the "amount" of penalties as $14 million is factually incorrect.[86] The $14 million includes the penalties

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[85] Super. Ct. Op., at *11. In so ruling, the trial court observed that Delaware's ability to impose a tax is not affected by the fact that "the mortgages were originated or approved somewhere else nor that the funds for the mortgages came through Pittsburgh." Super. Ct. Op., at *12 (citing *J.C. Penney*, 311 U.S. at 444 (holding that "[t]he fact that the tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.")).

[86] The Superior Court adopted the Bank's incorrect computation: "The Commissioner also assessed late payment penalties amounting to $14,515,474 for 2000-2003, and also another penalty of $5,251.74 for each day after May 20, 2005 that the assessments remain unpaid." *See* Super. Ct. Op., at *3.

($4 million) *plus* the additional tax liability assessed ($10 million), as of the date of the Commissioner's decision (May 20, 2005).[87] Thus, the penalties imposed totaled $4 million, not $14 million as the Bank claims.

Turning to the legal merits, the Commissioner assessed penalties under Section 1104(e), which provides that "[i]f any banking organization . . . shall fail to pay any tax due under this chapter on or before the due date, a penalty of 0.05 percent shall be assessed for each day that the same shall remain unpaid after such date."[88] The Commissioner refused to abate the penalties, holding that the amount was appropriate "in relation to the activities [the Bank] conducted and the income it earned in [Delaware]," and was not excessive even though "the review of the Bank's franchise tax returns for the years at issue did not begin until after March 2003."[89] Under Section 1114, the Commissioner "is *authorized* to abate the unpaid portion of the assessment of any tax, interest, penalty, additional amount or addition to the tax, or any liability in respect therefore, which is . . .

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[87] As of the date of oral argument before this Court, the amount of the penalties, exclusive of additional tax, was approximately $7.8 million.

[88] 5 *Del. C.* § 1104(c). Chapter 5 contains two other provisions establishing penalties in connection with the bank franchise tax (§ 1104(a) and (c)), which are not applicable here.

[89] Comm. Dec., p. 21.

[e]xcessive in amount."[90] The usage of the word "authorized" indicates that the Commissioner has discretion whether or not to abate. The Internal Revenue Code ("IRC") contains a virtually identical abatement provision,[91] which has been construed as conferring discretionary power to the taxing authority.[92]

In considering whether to exercise that discretionary power, the Commissioner held that the phrase "excessive in amount" should not be given "an expansive meaning that includes some general notion of equitable fairness."[93] Starting from that premise, the Commissioner mechanically applied the statutory percentage rate to the additional tax liability assessed, as of March 1, 2001 (the due date for the 2000 tax). Federal District Courts and the United States Tax Court have held that a taxing authority abuses its discretion if it denies a taxpayer's abatement request "arbitrarily, capriciously, or *without sound*

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[90] 5 *Del. C.* § 1114(a.1) (italics added). Although the Commissioner is authorized to abate both tax assessments and penalties, the Bank is only disputing the Commissioner's refusal to abate the penalties.

[91] *See* I.R.C. § 6404(a)(1). *See also* 30 *Del. C.* § 538 (Chapter 30's abatement provision, virtually identical to the IRC provision).

[92] *See Matter of Bugge,* 99 F.3d 740, 744 (5th Cir. 1996); *Wright v. C.I.R.,* T.C.M. 2004-69, at *2 (U.S. Tax. Ct. 2004).

[93] Comm. Dec., p. 21. *But see Edelson v. C.I.R.,* 829 F.2d 828, 832 n.4 (9th Cir. 1987) (noting that the Commissioner is free to forgive a portion of the tax, should the taxpayers apply for "executive clemency").

basis in fact or law."[94] Here, the record does not disclose any basis in fact for the Commissioner's refusal to abate, because the Commissioner recited no specific facts to support its decision. We recognize that the applicable Delaware statutes (Sections 1104(e) and 1114(a), defining the penalty and, respectively, authorizing abatement) afford little guidance as to the factors to be considered when assessing (and when deciding whether to abate) a bank franchise tax penalty. The counterpart provisions of the IRC and of Chapter 30 (Taxation) of the Delaware Code are instructive in this regard, however.[95]

Both Section 6651(a) of the IRC and Section 534 of Chapter 30 distinguish between penalties for failure to file a return that results in failure to pay the tax, and penalties for failure to pay additional tax

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[94] *Beall v. U.S.*, 335 F.Supp.2d 743, 748 (E.D. Tex. 2004) (emphasis added); *Dadian v. Comm'r*, 2004 WL 1118291 at *3 (U.S. Tax Ct. 2004) (citing *Woodral v. Comm'r*, 112 T.C. 19, 23 (U.S. Tax Ct. 1999)). State courts have also specifically held that a tax authority's refusal to abate penalties may not be arbitrary. *See, e.g., J.M. Smucker, LLC v. Levin*, 865 N.E.2d 866, 869 (Ohio 2007); *Patel v. Director, Div. of Taxation*, 13 N.J. Tax 509, 515 (N.J. Tax. Ct. 1993); *Norris v. Commonwealth*, 625 A.2d 179, 182-83 (Pa. Commw. 1993).

[95] It is proper to look at the general taxation principles contained in the Delaware Code, because several provisions in Chapter 5 (Banking) specifically cross-reference Chapter 30 (Taxation). Moreover, this Court has looked at similar federal tax provisions when a Delaware tax statute was ambiguous. *See Director of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003); *Logan v. Davis*, 191 A.2d 1, 5 (Del. 1963).

assessed following the taxing authority's review of a filed return.[96] Failure to file a return (which did not occur here) results in higher penalties, which are calculated to run from the day that the return should have been filed. In contrast, where a return is filed and additional tax is assessed, a penalty is due only if the taxpayer fails to pay the balance within a prescribed period of time from the assessment.[97]

Here, the Commissioner assessed penalties at a daily rate of 0.05% per day, running from March 1, 2001, when the 2000 bank franchise tax first became due. To assess penalties from March 2001, in a case where no additional tax liability was assessed until October 2003, appears arbitrary.[98] The Commissioner insists that it was not required to notify the Bank of the deficiency any sooner than it did, because the statute contains a three year period of limitations,

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[96] *See* I.R.C. § 6651(a) and 30 *Del. C.* § 534.

[97] Regrettably, 5 *Del. C.* § 1104(e) makes no such distinction.

[98] The Commissioner imposed penalties from the due date of the tax for each year in question, not from the date of the notice of assessment. That computation finds no support in Chapter 30 or the IRC, which provide that, where additional tax is imposed, both penalties and interest may be imposed, but only *from the date of the notice of the proposed assessment* and only if the additional tax assessed is not paid within a certain period of time following that notice. *See* 30 *Del. C.* §§ 533 and 534 and I.R.C. §§ 6601 and 6651. We note that only "penalties" may be imposed under Chapter 5 because Chapter 5 does not mention "interest." The Commissioner, therefore, correctly did not assess interest.

which was observed.[99] But the statute of limitations is not the only factor informing the sound exercise of discretion. 30 *Del. C.* § 521(a) directs that "*[a]s soon as practicable* after any return is filed, the [tax authority] shall examine it to determine the correct amount of tax."[100] Here, the Commissioner's office did not object to the Bank's 2000 Franchise Tax Return until nearly three years after that return was filed. Indeed, not until the Commissioner's October 6, 2003 letter was the Bank told that its Returns for the tax years 2000-2002 were incorrect. Only at that time was the Bank's liability recalculated based on the disallowance of the line 4(b) deduction.

The Commissioner rejected without explanation the Bank's contention that the three year administrative delay justified an abatement of penalties. Before this Court, the Commissioner claims that the delay was attributable to the Bank's failure to submit the requested documentation in support of the line 4(b) deduction. That argument is flawed. The Bank did provide certain apportionment schedules, and the Commissioner and the Superior Court found that those schedules were insufficient to support a line 4(b) deduction. But, during oral argument before this Court, the Commissioner conceded that the submission of *any* documentation, however sufficient, would have been "irrelevant," because the line

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[99] *See* 5 *Del. C.* § 1111.

[100] 30 *Del. C.* § 521(a) (emphasis added).

4(b) deduction was simply not available to the Bank as a matter of law.[101] Accordingly, for penalty abatement purposes, the Commissioner may not rely on the Bank's failure to provide sufficient supporting documentation.

Finally, Chapter 30 and the IRC provide that penalties should not be imposed when the failure to pay the additional tax liability assessed is "due to reasonable cause and not due to willful neglect."[102] The United States Supreme Court held that "reasonable cause" exists where a taxpayer demonstrates that it exercised "ordinary business care and prudence," and that "willful neglect" means "conscious, intentional failure or reckless indifference."[103] Although it is for the Commissioner, not this Court, to determine whether the Bank met these requirements, it is noteworthy that: (i) the Bank filed its original Franchise Tax Returns consistent with the practice of its predecessor; (ii) the timeliness of the Bank's filings is undisputed; (iii) the Bank requested, and relied upon, the opinion of an independent tax advisor (Ernst & Young) before amending its returns in

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[101] As explained above, that deduction applies solely to entities that have out-of-state branches or subsidiaries. The Bank had no such branches or subsidiaries during the relevant period.

[102] *See* I.R.C. § 6651(a)(3) and 30 *Del. C.* § 534(b)(2).

[103] *Director of Revenue v. J.E. Rhoads & Sons, Inc.*, 628 A.2d 1388, 1390 (Del. 1993) (citing *United States v. Boyle*, 469 U.S. 241, 245-46 (1985).

August 2004; (iv) the Bank later obtained the opinion of a second independent tax advisor (PricewaterhouseCoopers); (v) the Bank contested in good faith the assessment of additional tax liability, before the Commissioner, the Superior Court, and this Court; and (vi) the Bank's legal position with respect to the original and the amended Franchise Tax Returns was not frivolous, and the filing of those Tax Returns was not fraudulent.

Because the Commissioner failed to consider any of the above-described circumstances, we are constrained to conclude that the Commissioner abused its discretion by refusing to abate, in an appropriate way, the penalties assessed. It follows that, in affirming the Commissioner's decision, the Superior Court legally erred. Therefore, the penalty provision of the Superior Court order will be reversed, and the case will be remanded with instructions that the Superior Court remand the case to the Commissioner to reconsider the Bank's request for abatement of penalties, in accordance with this Opinion.

CONCLUSION

For the reasons set forth, the judgment of the Superior Court is affirmed in part, and reversed in part and remanded for further proceedings in accordance with this Opinion.

APPENDIX B

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Case Number 656,2006-D

IN THE SUPREME COURT
OF THE STATE OF DELAWARE

LEHMAN BROTHERS BANK, FSB, Appellant Below, Appellant, v. STATE BANK COMMISSIONNER [sic], Appellee Below, Appellee.	§ § § § § § § § § § §	No. 656, 2006 Court Below: Superior Court of the State of Delaware in and for New Castle County C.A. No. 05A-06-004

Submitted: May 23, 2007
Decided: November 7, 2007

Before **HOLLAND**, **JACOBS** and **RIDGELY**, Justices.

Upon Appeal from the Superior Court. **AFFIRMED IN PART, REVERSED IN PART and REMANDED.**

Stanford L. Stevenson, III and Anne Shea Gaza, Esquires, of Richards, Layton & Finger, Wilmington, Delaware; Of Counsel: Paul H. Frankel (argued) and Irwin M. Slomka, Esquires, of Morrison & Foerster, LLP, New York, New York; for Appellant.

Thomas P. McGonigle, Esquire, of Wolf, Block, Schorr and Solis-Cohen, LLP, Wilmington, Delaware; Of Counsel: Joseph C. Bright (argued) and Cheryl A. Upham, Esquires, of Wolf, Block, Schorr and Solis-Cohen, LLP, Philadelphia, Pennsylvania; for Appellee.

JACOBS, Justice:

Appellant Lehman Brothers Bank, FSB appeals from a Superior Court Order[1] affirming a decision by the State Bank Commissioner (the "Commissioner")[2] assessing additional franchise tax and penalties against the Bank for the tax years 2000, 2001, 2002 and 2003. We affirm that portion of the Order upholding the imposition of additional franchise tax, reverse that portion upholding the assessment of penalties, and remand the case for further proceedings.

FACTS AND PROCEDURAL BACKGROUND

The material facts are undisputed. Since the 1980s, Lehman Brothers Holdings, Inc. ("LBH") has operated a mortgage business whose activities consist of acquiring, and earning interest on, mortgages issued by independent mortgage lenders and brokers or by LBH's subsidiary mortgage company, Aurora

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[1] *Lehman Bros. Bank, FSB v. State Bank Commissioner*, 2006 WL 3457649 (Del. Super.) (cited herein as "Super. Ct. Op.").

[2] Decision of the Delaware State Bank Commissioner, dated May 20, 2005 (cited herein as "Comm. Dec."). Any references in this Opinion to the Commissioner are to the office of the Commissioner, not to the particular occupant of that office.

Loan Services, Inc. ("Aurora"). Before 1999, LBH's mortgage business was funded by unsecured bank loans, commercial paper, or short and long-term repurchase agreements. Because this type of funding was unstable, LBH actively sought to acquire a federal savings bank, specifically to gain access to Federal Home Loan Bank ("FHLB") funding, which was a more stable and efficient funding source.

In 1999, LBH acquired Delaware Savings Bank, FSB, a federal savings bank organized under the Federal Home Owner's Loan Act, and subject to regulation and supervision by the United States Office of Thrift Supervision, and changed its name to Lehman Brothers Bank, FSB (the "Bank"). The Bank's federal stock charter, which became effective on June 30, 1999, designated Wilmington, Delaware as the Bank's "home office." That designation enabled the Bank to access FHLB funds from the Pittsburgh FHLB.

The Bank maintained a retail banking office—located in Wilmington, Delaware—for personal banking services. That retail operation was not profitable. The Bank's profitable operation was its mortgage banking business.[3] In that latter business, the Bank had two primary sources of funds for acquiring mortgages: (i) funds derived from sales of certificates of

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[3] In addition to its retail and mortgage banking activities, the Bank conducted a trust services operation, beginning in 2002.

deposit (representing 25-30% of the total funds) and (ii) funds derived from FHLB loans (representing 50-60% of the total). Using those funds, the Bank acquired mortgages in one of three ways: outright purchase,[4] direct origination,[5] and origination through a correspondent lender.[6] The Bank customarily held the mortgages for 45-60 days—a practice generating interest income that represented about 97% of the Bank's total income. After 45-60 days, the Bank then "sold" the mortgages to its parent company, LBH, making no profit on the transfer.

Most of the Bank's senior management was based in New York, and the Bank's board of directors met approximately eight times a year in New York. For the tax years in question, about 12 persons were employed at the Delaware home office. Half of the Delaware employees engaged in retail banking activities, and half performed accounting and other support services for the Bank as a whole. To conduct its mortgage banking business, the Bank employed 20-25 full-time direct employees in New York (all on the Bank's payroll), 66 "dual employees" in New York

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[4] The Bank bought residential mortgage pools that were already issued and funded.

[5] A borrower who wanted a mortgage would apply to Aurora, which would approve the borrower's credit and the mortgage under the Bank's guidelines. Aurora's services were usually performed in Colorado.

[6] Another lender would underwrite and fund the loan and would then sell the mortgage to the Bank, through Aurora.

(persons on LBH's payroll, for whose services the Bank reimbursed LBH), and 24 "dual employees" in Colorado (persons on Aurora's payroll, but for whose services the Bank reimbursed Aurora).

For each of the years at issue (2000-2003) the Bank filed a Delaware Franchise Tax Report. Delaware imposes a bank franchise tax on the taxable income of banking organizations for the privilege of doing business in this State.[7] The measure of the franchise tax depends importantly on whether the banking organization (here, a federal savings bank) is domiciled in Delaware.[8] Under 5 *Del. C.* § 1101(a) ("subsection (a)"), a federal savings bank with its "principal office" in Delaware is taxed on all its taxable income.[9] But, under line 4(b) of its Return, a bank may deduct from its reported income the portion that was earned from activities conducted outside Delaware by branches or subsidiaries subject to income taxation under the laws of another state (a "line 4(b) deduction").[10] Under 5 *Del. C.* § 1101(b)

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[7] *See* Super. Ct. Op. at *4.

[8] *See* 5 *Del. C.* § 1101.

[9] 5 *Del. C.* § 1101(a) and 5 *Del. C.* § 101(4)(b).

[10] Under Section 1101(a)(1)(b)(2), a Delaware bank with out-of-state branches and subsidiaries may reduce its "taxable income" by "[t]hat portion of the net operating income before taxes, verifiable by documentary evidence ... which is ... [d]erived from business activities carried on outside [Delaware] and subject to income taxation under the laws of another state."

("subsection (b)"), a federal savings bank not "headquartered" in Delaware is subject to a more limited bank franchise tax, imposed only on the income of the bank's Delaware branches or subsidiaries, if any. The Delaware bank franchise tax statute does not define the terms "principal office" or "headquartered." For ease of reference, we sometimes refer to either of those terms, or both interchangeably, as "domicile," or "domiciled."

For the year 2000, the Bank filed its Franchise Tax Return under subsection (a), as had its predecessor (the Delaware Savings Bank), as a banking organization having its "principal office" in Delaware. For that tax year, the Bank reported all its income, but claimed a line 4(b) deduction to reflect its income from activities conducted outside Delaware, even though the Bank had no formally established out-of-state branches or subsidiaries. The Commissioner's office made no objection to the Bank's 2000 Franchise Tax Return for nearly three years.

The Bank used the same approach in filing its Franchise Tax Return for the tax year 2001. The Bank filed its 2001 Return (in 2002) under subsection (a), as a banking organization having its "principal office" in Delaware, and again claimed a line 4(b) deduction. Thereafter, the Commissioner contacted the Bank to discuss the Return. During those discussions, the Commissioner requested, among other things, documentation to support the line 4(b) deduction. The statute allowing that deduction authorizes the taxpayer to deduct "net operating income before

taxes *verifiable by documentary evidence* from any subsidiary or . . . branch."[11] In response to that request, the Bank submitted, in March 2003, two "apportionment schedules," consisting of one-page charts listing income purportedly allocated and reported to other states.

In 2003, the Bank filed its 2002 Franchise Tax Return, again under subsection (a), and again claiming a line 4(b) deduction. By letter dated October 6, 2003, the Commissioner advised the Bank that its Returns for the tax years 2000-2002 were incorrect, because (in the Commissioner's view) the Bank had no basis to claim a line 4(b) deduction. The Commissioner then recalculated the Bank's tax liability based on the disallowance of the line 4(b) deduction, and also assessed "late penalties." The Bank disputed both the assessment and the penalties. That dispute prompted the Commissioner to issue a notice of proceedings under 29 *Del. C.* § 10122 for purposes of finally determining the Bank's franchise tax liability for tax years 2000, 2001, and 2002.

In response to the Commissioner's disallowance of the line 4(b) deduction in its 2000-2002 Returns, the Bank did not claim that deduction in its 2003 Franchise Tax Return (filed in 2004). The Bank filed its 2003 Return under subsection (a)—as before—but instead of claiming a line 4(b) deduction, the Bank

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[11] 5 *Del. Admin. C.* § 1105, Item 4(b), based on 5 *Del. C.* § 1101(a)(1)(b)(2) (emphasis added).

reported only that portion of its income it claimed to be attributable to Delaware.[12] On August 2, 2004, the Commissioner issued a revised notice of proceedings, this time covering the Bank's franchise tax liability for all four years in question, *i.e.* 2000-2002 and 2003. An evidentiary hearing before the Commissioner was scheduled for September 30 and October 1, 2004.

After it received the Commissioner's August 2, 2004 notice, the Bank submitted amended Franchise Tax Returns for all four tax years. The basis for the amended Returns was that, for all the years at issue, the Bank was not domiciled in Delaware, contrary to what the Bank had represented in its original Returns. Therefore, the Bank should be taxed under subsection (b), only on the income earned from its Delaware operations. In submitting those amended Returns, the Bank reported that it used a separate accounting method, based on a study prepared by Ernst & Young, to segregate the income generated by the Bank's Delaware retail operations from the income generated by the Bank's "nationwide" mortgage and trust operations. Based on that accounting method, the Bank claimed that it was entitled to tax refunds for all four years, totaling approximately $14 million.

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[12] The income reported on the 2003 Franchise Tax Return was, therefore, significantly less than the amounts reported on the Tax Returns filed for the previous three years.

After the evidentiary hearing, the Commissioner determined that because the Bank was domiciled in Delaware, subsection (a) of Section 1101 was applicable. The Commissioner further decided that the Bank was not entitled to claim a line 4(b) deduction, because it had no out-of-state "branches" or "subsidiaries." Therefore, the Commissioner concluded that a franchise tax balance of $10.5 million was due, and assessed "late penalties" for each tax year, at a daily rate of 0.05% of the balance, to accrue until the additional assessed tax was paid. As of May 20, 2005 (the date of the Commissioner's decision), the "late penalties" totaled approximately $4 million.[13]

The Bank appealed to the Superior Court, which upheld the Commissioner's decision. The Superior Court held that: (i) the Bank was domiciled in Delaware for franchise tax purposes; (ii) all of the Bank's interest income was earned in, and derived from, Delaware; (iii) the Commissioner's method of assessing the tax did not violate the Commerce or the Due Process Clauses of the United States Constitution;

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[13] *See* Comm. Dec. pp. 17-21. The total assessment of $14,515,474 was divided as follows: (1) for 2000: $3,209,996 franchise tax assessed; $854,996 balance due; $658,778 penalty; (2) for 2001: $4,936,270 franchise tax assessed; $1,726,410 balance due; $1,015,123 penalty; (3) for 2002: $7,715,354 franchise tax assessed; $3,144,482 balance due; $1,275,087 penalty; and (4) for 2003: $11,577,586 franchise tax assessed; $4,777,586 balance due; $1,063,012 penalty.

and (iv) the Commissioner did not abuse its discretion by refusing to abate the tax assessment and the penalties.

This appeal followed.

THE CLAIMS OF ERROR: AN OVERVIEW

On appeal, the Bank advances several claims of error. The Bank first claims that the Commissioner and the Superior Court reversibly erred by concluding that the Bank was domiciled in Delaware and, thus, subject to Section 1101(a). The Bank takes the position that it was (and is) domiciled in New York, because most of the Bank's employees, including its senior management, work in New York. Therefore, the Bank claims, the applicable franchise tax provision is not Section 1101(a), but Section 1101(b), under which only the income attributable to a Delaware "branch" is subject to tax.

Second, and alternatively, the Bank argues that even if Section 1101(a) is the applicable statute, the Commissioner and the Superior Court reversibly erred in holding that the Bank was subject to Delaware bank franchise tax on 100% of its income. That was error, the Bank contends, because (i) the Bank did not earn all of its income in Delaware, and (ii) the statutorily prescribed manner of assessing the tax violates the Commerce and the Due Process Clauses.

Third, the Bank claims that the Superior Court reversibly erred in finding that the Commissioner

properly refused to abate the penalties. Fourth, the Bank argues that if this Court finds that the Bank is entitled to a tax refund, the Bank is entitled to pre-judgment interest on that refund. These claims generate the issues presented on this appeal.

The first issue is whether the Bank is domiciled in Delaware. If the Bank is *not* domiciled in Delaware, then Section 1101(b) applies a the Bank's amended Franchise Tax Returns—filed under Section 1101(b)—were correct, thereby entitling the Bank to a tax refund. If, however, the Bank is domiciled in Delaware, then the Bank is subject to Section 1101(a), in which case the question becomes whether the Bank was entitled to a line 4(b) deduction. We conclude that the Bank was domiciled in Delaware, and that under the applicable statute—Section 1101(a)—the Bank was not entitled to apportion its income by taking a line 4(b) deduction.

The next set of issues involve whether the Delaware bank franchise tax statute violates the Commerce and/or the Due Process Clause. We hold that the apportionment mechanism contained in the Delaware statute (which is not available to the Bank in this case) passes constitutional muster under the Commerce and the Due Process Clauses.

The final issue is whether the Commissioner abused its discretion by refusing to abate the penalties assessed. We conclude that in these specific circumstances the Commissioner abused its discretion by not

abating the penalties and that the Superior Court erred in holding otherwise.

STANDARD OF REVIEW AND ANALYSIS OF THE CLAIMS OF ERROR

In reviewing an administrative agency's decision, this Court determines whether the factual findings of the agency are "supported by substantial evidence on the record before the agency."[14] Where, as here, the agency has interpreted and applied statutory provisions, those determinations involve questions of law[15] that this Court reviews *de novo*.[16]

Section 1101(a) Is Applicable Because The Bank Was Domiciled in Delaware

Section 1101(a) of the bank franchise tax statute applies to federal savings banks having their "principal office" in Delaware. Section 1101(b) applies to federal savings banks that are not "headquartered" in Delaware. From the structure of Section 1101, it is evident that the terms "principal office" and "headquarter[s]"

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[14] *Public Water Supply Co. v. DiPasquale*, 735 A.2d 378, 380-81 (Del. 1999) (citing *Stoltz Mgmt. Co., Inc. v. Consumer Affairs Bd.*, 616 A.2d 1205, 1208 (Del. 1992)).

[15] *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 349 (Del. 1993); *Bd. of Educ. of Smyrna School Dist. v. DiNunzio*, 602 A.2d 85, 92-93 (Del. 1990); *Public Water*, 735 A.2d at 380-81.

[16] *Del. Bay Surgical Serv., P.C. v. Swier*, 900 A.2d 646, 652 (Del. 2006) (citing *Coastal Barge Corp. v. Coastal Zone Ind. Control Bd.*, 492 A.2d 1242, 1246 (Del. 1985)).

are used interchangeably.[17] Neither term is defined in Chapter 5 (Banking) of the Delaware Code, of which Section 1101 is a part. This Court must therefore ascertain the meaning of those terms, which requires us to interpret the Delaware bank franchise tax statute, as applied to a federal savings bank.

The Bank argues that in interpreting the statute, the terms "principal office" and "headquarter[s]" must be given their ordinary meaning. According to the Bank, the ordinary meaning is "commercial domicile," defined as "the place from which the trade or business is principally managed or directed."[18] Under that definition the Bank's "commercial domicile" would be New York, because the Bank's executive officers are employed in New York, its board of directors meets exclusively in New York, its regulatory examinations are conducted in New York, and

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[17] *See Chrysler Corp. v. State,* 163 A.2d 239, 241 (Del. 1960) (holding that where similar terms are used in different subsections of the same provision, those terms should be construed to have the same meaning). The Report on "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories" of the United States Advisory Commission on Intergovernmental Relations, dated May 1975 (the "ACIR Report") recognizes that the terms "domicile," "principal office," "home office," and "headquarters" are synonymous. *See* ACIR Report, p. 53.

[18] The "ordinary meaning" definitions suggested by the Bank are extracted either from dictionaries or from regulations that are not applicable in Delaware: the Uniform Division of Income for Tax Purposes Act (UDITPA) and a Model Statute adopted by the Multistate Tax Commission (MTC). Delaware has not adopted the UDITPA and is not a member of the MTC.

most of its mortgage-related decisions are made in New York.

We disagree with the Bank's interpretation. The rule of construction which requires that an undefined statutory term be given its ordinary meaning does not apply to terms of art. Under the general rules of statutory interpretation set forth in the Delaware Code, "technical words and phrases . . . [must] be construed and understood according to [their] peculiar and appropriate meaning."[19] Here, the terms "principal office" and "headquarter[s]" are terms of art and, therefore, must be given their "peculiar and appropriate meaning." Because those terms are used in a statute imposing a tax upon "banking organizations"—entities that include federal savings banks—we conclude that the appropriate meaning of "principal office" and "headquarter[s]" is the meaning accorded those terms by the regulations that govern federal savings banks and their taxation.

The Code of Federal Regulations (CFR)[20] requires that all federal savings banks designate a "home

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[19] 1 *Del. C.* § 303. *See also Shell Petroleum, Inc. v. U.S.*, 182 F.3d 212, 217-18 (3rd Cir. 1999) (citing *Corning Glass Works v. Brennan*, 417 U.S. 188, 202 (1974)).

[20] This Court has used federal definitions when a Delaware tax statute did not clearly define a term. *See Director of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003). Several provisions in Chapter 30 (Taxation) of the Delaware Code actually require that certain statutory terms be given the same meaning as when used in federal laws. *See, e.g.*, 30 *Del. C.* § 502(a), § 1101, § 2071. *See also Gow v. Director of Revenue*, 556 A.2d 190, 193 (Del. 1989).

office."[21] Under the CFR, "home office" is synonymous with "principal office." The latter term is employed in Section 1101 of the Delaware statute.[22] Here, the Bank's federal stock charter explicitly designates Wilmington, Delaware as the "home office." The CFR further mandates that if a federal bank wishes to change its home office address, it must apply to the United States Office of Thrift Supervision ("OTS").[23] The Bank has never applied to the OTS to change the location of its Wilmington, Delaware home office. Therefore, under the CFR, the Bank is domiciled in Delaware.

Other applicable regulations lead to the same conclusion. 12 U.S.C. § 1424(b) prescribes that a federal savings bank "may become a member *only* of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's *principal place of business.*"[24] Here, the Bank borrowed exclusively from the FHLB in Pittsburgh, which serves Delaware—but not New York—federal

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[21] *See* 12 C.F.R. § 545.91(a) which provides that "[a]ll operations of a Federal savings association are subject to direction from the home office."

[22] *See* 12 C.F.R. § 561.39 ("The term principal office means the home office of a savings association established as such in conformity with the laws under which the savings association is organized.") *See also* 12 C.F.R. § 925.18(b) ("the principal place of business . . . is the state in which the institution maintains its home office.")

[23] *See* 12 C.F.R. § 545.91(b).

[24] 12 U.S.C. § 1424(b) (emphasis added).

savings banks. We regard this course of conduct as evidence that the Bank considered its "principal place of business" to be Delaware, not New York.

The Delaware bank franchise tax statute also points to the conclusion that the Bank is domiciled in Delaware. Although that statute does not define "principal office" and "headquarter[s]," it does define a similar term—"located"—that appears in *both* subsections of Section 1101.[25] Under 5 *Del. C.* § 831(8), a savings institution is "located" in "the state in which the amount of aggregate deposits of all its offices in that state is greatest."[26] The Bank had only one office where its deposit operations were conducted. That office was located in Delaware.

Finally, we note a recent amendment to the Delaware bank franchise law that defines, for the first time, the term "headquarters." Under the new provision, the "headquarters" of a national banking association are located "in the state of the bank's

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[25] Section 1101 cross-references Section 801(5) for the definition of the word "located." Section 801(5) provides that a bank is "located" in Delaware if the "organization certificate identifies an address in [Delaware] as the place at which its discount and deposit operations are to be carried out." That definition is applicable to state-chartered banks and national banks. However, a similar definition, specifically applicable to savings institutions, is contained in Section 831(8).

[26] 5 *Del. C.* § 831(8).

home office as designated in its charter."[27] Although that amendment is effective for tax years post-2006 (and, thus, not applicable here), the definition it adopts is instructive and fully supports the interpretation reached here.[28]

For these reasons, we conclude that both the Commissioner and the Superior Court correctly held that the Bank was domiciled in Delaware for franchise tax purposes. As a consequence, Section 1101(a) was the applicable provision for computing the Delaware bank franchise tax.

The Bank Is Not Entitled To A Line 4(b) Deduction Under Section 1101(a)

Under Section 1101(a), the entire net income of federal savings bank domiciled in Delaware is taxed by Delaware, unless that entity has an out-of-state "branch" or "subsidiary." In that case, the income attributable to the branch or subsidiary may be deducted from the total reported income, subject to certain limitations. For a line 4(b) deduction to be available, however, the income sought to be excluded must be: (a) derived from business activities carried

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[27] *See* 5 *Del. C.* § 1101A(c)(9) (emphasis added). National banks are subject to regulations which are very similar to those governing federal savings banks.

[28] *See Chrysler Corp. v. State,* 163 A.2d 239, 241 (Del. 1960) ("A change in the phraseology of the amendment creates a presumption that the Legislature intended a change of meaning.")

in other states through "branches" or "subsidiaries," (b) "verifiable by documentary evidence," and (c) subject to income taxation under the laws of another state.[29] The Superior Court and the Commissioner held that the Bank did not satisfy these conditions. We uphold their determination.

Regarding the first condition, it is undisputed that the OTS must approve the establishment of "branches" and "subsidiaries,"[30] and that during the years in question the Bank had no OTS-approved branches or subsidiaries.[31] The Bank requested OTS' approval to open a branch in New Jersey (to be effective January 2004), but it never sought OTS' approval to establish a New York branch. Rather, the Bank applied only for approval of an "agency office" in New York, "solely to conduct trust activities." The distinction is significant, because "agency offices" are expressly excluded from the CFR definition of "branch."[32]

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[29] *See* 5 *Del. C.* § 1101(a); 5 *Del. Admin. C.* § 1105, Item 4(b).

[30] *See* 12 C.F.R. §§ 545.93(a), 559.3 and 559.11.

[31] Until January 2004, the Bank had no out-of-state branches, and its only Delaware branch closed in December 2000. On August 6, 2003, the Bank applied to the OTS for approval to open a branch in New Jersey, which was granted, effective January 26, 2004. *See* Comm. Dec., p. 6.

[32] "Any office *other than* [the] home office, *agency office,* administrative office, data processing office, or an electronic means or facility." *See* 12 C.F.R. § 545.92(a) (emphasis added).

The Bank asserts, nonetheless, that for franchise tax purposes it had *de facto* branches in the other states to which it "paid more than $106 million in state and local income taxes."[33] This argument has no legal force. Congress has decreed that any "branches" must be approved by the OTS. That requirement reflects a policy judgment that a branch is more than a verbal label—it is a geographical location where a monopoly activity may be lawfully conducted.[34] Because approval of a branch authorizes the taking of deposits and the making of loans by the branch exclusively at that particular location, there is no such thing as a *de facto* branch in the federally regulated banking industry.

Faced with this insurmountable legal obstacle, the Bank attempts to circumvent it by arguing that requiring a taxpayer bank to establish a formal branch to avail itself of the line 4(b) deduction "does not reflect modern banking practices." Under such "modern practices," the Bank asserts, certain mortgage banking related activities may be conducted

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[33] This assertion is based on a report prepared by PricewaterhouseCoopers, which contains a one-page chart listing other states where the Bank paid taxes during the years at issue (*e.g.* New York, California and Colorado) and the amounts paid in each state.

[34] Delaware regulations similarly make the opening of a branch by a state bank subject to the State Bank Commissioner's approval. A branch is defined as "any location . . . at which deposits are received or checks paid or money lent." *See* 5 *Del. C.* § 770(a)(1).

without prior OTS approval, through an out-of-state "agency office." It is the case that federal savings banks are allowed, under federal law, to conduct limited activities through agency offices without OTS approval.[35] Even so, this limited exception does not aid the Bank's position, because the Delaware bank franchise tax statute permits a line 4(b) deduction only on income earned by an out-of-state "branch" or "subsidiary," and, under federal law, an "agency office" is not a "branch." Accordingly, the Commissioner properly held that the absence of any OTS-approved branches or subsidiaries precludes the Bank from taking advantage of the line 4(b) deduction.

Even if we accepted the Bank's argument that an OTS-approved branch was not required to enable the Bank to take a line 4(b) deduction, other conditions for utilizing that deduction remain unsatisfied. First, the Bank failed to provide (either at the time of filing or after) "documentary evidence" verifying that the portion of the income it sought to exclude from the taxable income reported in Delaware was "derived from business activities carried in other States."[36] The only documents furnished by the Bank were "apportionment schedules" that listed the percentages of the

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[35] *See* 12 C.F.R. § 545.96. Those activities are limited to "[s]ervicing, originating, or approving loans and contracts" and "managing or selling real estate."

[36] 5 *Del. C.* § 1101(a)(1)(b)(2); 5 *Del. Admin. C.* § 1105, Item 4(b).

Bank's total income that were "allocated" to other states. Those schedules did not explain how those percentages were calculated, and, moreover, covered only tax years 2000 and 2002, even though the Bank also claimed the line 4(b) deduction for tax year 2001. As the Superior Court noted, the Bank should have prepared "a separate Delaware balance sheet accounting for the money earned in Delaware."[37] Second, the Bank failed to prove that other states were taxing the line 4(b) deducted income. As the Superior Court found, the Bank did not establish whether the other states "taxed the same mortgage interest income, or if they taxed other transactions, such as an origination fee or transfer fee."[38]

The Bank Is Not Entitled To Any Other Apportionment

Having determined that the Bank was not entitled "to account for its out-of-state operations" by taking a line 4(b) deduction, we must decide whether the Bank was allowed to apportion its income in some different manner. The Bank claims that, to the extent the Delaware statute does not allow apportionment, the United States Constitution requires that result.

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[37] Super. Ct. Op., at *7.

[38] Super. Ct. Op., at *7. The only evidence produced by the Bank is the one-page chart included in the Pricewaterhouse-Coopers report confirming the accuracy of Ernst & Young's analysis regarding the separate accounting method used in the amended Franchise Tax Returns.

Specifically, the Bank argues that the Commissioner and the Superior Court reversibly erred in holding that Delaware could tax 100% of the Bank's income because (i) in fact, the Bank did not earn all of its income in Delaware, and (ii) the tax assessed on that counterfactual basis violates the Commerce and the Due Process Clauses.

We initially dispose of the Bank's first argument. The Bank goes to great pains to argue that the activities which generated its mortgage-related funding and income "all took place outside Delaware, principally in New York." Both the Superior Court and the Commissioner determined, however, that "all [the Bank's] income was actually earned in and derived from sources in Delaware."[39] Under Delaware's taxation scheme, the *entire* net income of a federal savings bank having its home office in Delaware is taxed by Delaware, except for income attributable to out-of-state branches or subsidiaries. Under that scheme, where the Bank's income was *in fact* earned is not a relevant inquiry, because the statute authorizes Delaware to tax the Bank's entire income.[40] To say it

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[39] Super. Ct. Op., at *6.

[40] *See* 5 *Del. C.* § 1101(a). Delaware's statutory scheme is in line with the recommendations of the ACIR Report on "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories" that where a financial depository is subject to franchise tax in more than one state, "*the domiciliary State* (ordinarily the State of the principal, headquarters, or home office) *may apply its tax on the entire income* . . . , but shall allow . . . a credit

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differently, to resolve the constitutional issues we need not determine what portion of the income was in fact earned in Delaware and what portion, if any, was in fact earned elsewhere.[41] Rather, the inquiry is whether Delaware's taxation scheme "reasonably" reflects the in-state component of the activity being taxed[42] (under the Commerce Clause) and whether there is a "rational" relationship between the taxed income and the values connected with the taxing state[43] (under the Due Process Clause). For the reasons next discussed, we conclude that Delaware's bank franchise tax statute passes muster under both constitutional provisions.

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against such tax liability for similar taxes paid to other States." *See* ACIR Report, p. 53 (emphasis added).

[41] In *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 273 (1978), the United States Supreme Court noted that most apportionment formulas are imprecise and "will occasionally over-reflect or under-reflect income attributable to the taxing State."

[42] *Goldberg v. Sweet,* 488 U.S. 252, 262 (1989). *See also Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159, 169 (1983) (holding that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated").

[43] *Moorman,* 437 U.S. at 273 (1978) (citing *Norfolk & Western R. Co. v. State Tax Comm'n,* 390 U.S. 317, 325 (1968)). *See also Quill Corp. v. North Dakota,* 504 U.S. 298, 305-06 (1992) (quoting *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-45, (1954)).

A. Commerce Clause Analysis

The Commerce Clause authorizes Congress to "regulate Commerce . . . among the several States."[44] Although the Commerce Clause is expressed as an "affirmative grant of power," the United States Supreme Court has consistently held that the Commerce Clause also contains a negative implication, known as the Dormant Commerce Clause, which prohibits certain state actions that interfere with interstate commerce.[45]

A taxpayer challenging a state taxation statute carries the burden of overcoming the presumption of constitutionality with clear and convincing evidence.[46] To determine a statute's constitutionality under the Dormant Commerce Clause, the United States Supreme Court has consistently applied the *Complete Auto Transit, Inc. v. Brady*[47] test. Under that test, a tax will be upheld if: (1) it is applied to an activity having a substantial nexus to the taxing state, (2) it

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[44] U.S. Const. Art. I, § 8, cl. 3.

[45] *See, e.g., Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-80 (1995); *Quill Corp. v. North Dakota*, 504 U.S. 298, 309 (1992); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959).

[46] *See Atlantis J Condo. Ass'n v. Bryson*, 403 A.2d 711, 714 (Del. 1979); *Justice v. Gatchell*, 325 A.2d 97, 102 (Del. 1974). In particular, a strong presumption of validity exists for the state taxing statutes. *See Kunkel's Estate v. U.S.*, 689 F.2d 408, 424 (3rd Cir. 1982). *See also Estate of Kunze v. C.I.R.*, 233 F.3d 948, 954 (7th Cir. 2000).

[47] 430 U.S. 274 (1977).

is fairly apportioned, (3) it does not discriminate against interstate commerce, and (4) it is fairly related to the services provided by the taxing state.[48] The Bank's Commerce Clause claim is limited to the second prong of *Complete Auto.*[49]

Specifically, the Bank argues that the Delaware bank franchise tax is not fairly apportioned, because the statute does not allow a federal savings bank that is domiciled in Delaware and has no out-of-state branches to apportion its income to account for income-generating operations conducted in other states. The Commissioner responds that the *Complete Auto* test, and its fair apportionment requirement, are inapplicable in this case. Therefore, we must first address a threshold issue: whether *Complete Auto* is applicable at all. We conclude that it is.

1) *Complete Auto Is Applicable*

The Commissioner contends that the *Complete Auto* test established to implement the Dormant Commerce Clause does not apply here, for two reasons. First, the Commissioner argues, Congress affirmatively exercised its power to regulate interstate commerce in this area by enacting Section

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[48] *See Complete Auto,* 430 U.S. at 279.

[49] The Bank does not dispute that the tax complies with *Complete Auto's* other three requirements. However, the Superior Court analyzed in detail all four prongs and concluded that each of them was satisfied. *See* Super. Ct. Op., at *9-10.

1464(h) of the Federal Home Owner's Loan Act (HOLA). Therefore, the Commerce Clause is not "dormant" and may not be used as a basis to attack the constitutionality of a Delaware statute adopted under the authority affirmatively delegated by the Congress to the states in Section 1464(h) of HOLA.

We conclude that the Dormant Commerce Clause is applicable. Section 1464(h) authorizes states to tax federal savings associations, but provides that such state taxes may not be "greater than that imposed . . . on other similar local mutual or cooperative thrift and home financing institutions."[50] That is, Congress affirmatively exercised its power to regulate the interstate commerce only in a limited way, *i.e.* to prohibit discriminatory state taxation of federal savings associations. Congress did not, however, affirmatively legislate to regulate any other aspect of state taxation of federal savings associations. As the United States Supreme Court has held, "federal regulation of a field of commerce should not be deemed preemptive of state regulatory power in the absence of persuasive reasons—either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained."[51] Here, there is no "unmistakable" evidence that Congress intended affirmatively to regulate the

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[50] *See* 12 U.S. Code § 1464(h), enacted in 1933.

[51] *Florida Lime & Avocado Growers, Inc. v. Paul,* 373 U.S. 132, 142 (1963).

entire field[52] of state taxation of federal savings banks. Therefore, Section 1646(h) of HOLA does not displace the Dormant Commerce Clause.

Second and alternatively, the Commissioner argues that even if the Dormant Commerce Clause applies *Complete Auto's* requirement of fair apportionment is limited to non-domiciliaries. Therefore, Delaware domiciliaries such as the Bank may be taxed without any apportionment restrictions. Stated differently, the Commissioner urges that "a state has the constitutional power to tax all of the income of its residents, no matter where that income is earned."[53]

The United States Supreme Court has not yet decided whether a state may constitutionally tax the *unapportioned* net income of a domiciliary entity that derives income from other states in which it conducts business. This issue was addressed, however, by the Supreme Court of Rhode Island in *Commercial Credit*

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[52] *See Southern Railway Co. v. D.L. Reid et al.*, 222 U.S. 424 (1912); *Lemke v. Farmers' Grain Co. of Embden*, 42 S. Ct. 244 (1922).

[53] Comm. Dec., at p. 15, citing *Oklahoma Tax Comm'n v. Chicksaw Nation*, 515 U.S. 450, 462-63 (1995); *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313 (1937); *Lawrence v. State Tax Comm'n*, 286 U.S. 276 (1932); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999). Those cases dealt with various taxes imposed upon pure "locals" (either resident *individuals* or domestic *corporations*) whereas here we must determine whether a specific tax (the bank franchise tax) is applicable to a specific entity (a *federal savings bank* with its "home office" in Delaware but conducting multi-state operations).

Consumer Services, Inc. v. Norberg.[54] That case (*Commercial Credit*) involved a tax similar to the one at issue here, on banking institutions organized or incorporated under the laws of Rhode Island (the taxing state). The tax was computed on "net income" from any sources. The Rhode Island statute allowed no apportionment, but permitted the domiciliary to deduct its ordinary and necessary expenses of doing business from "gross income." Those deductible expenses included taxes paid to other states in which the domiciliary conducted business. Underscoring the novelty of the issue, the Rhode Island Supreme Court held that "modern doctrine . . . appears to permit, either under the commerce clause or the due process clause, a state to tax [local] *businesses engaged in interstate commerce* so long as the tax is applied to an activity that bears a substantial nexus to the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state", *i.e.* the *Complete Auto* requirements.[55] After conducting a *Complete Auto* analysis, the Court concluded that the Rhode Island tax satisfied the Commerce Clause.[56] The

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[54] 518 A.2d 1336, 1337 (R.I. 1986).

[55] *Id.* (citing *Complete Auto,* 430 U.S. at 279) (emphasis added).

[56] Contrary to what the Bank argues, it is irrelevant that Rhode Island amended its relevant statute in 1995 to permit banks to apportion their income. *See People v. Regelin,* 443 N.W.2d 436, 438 (C.A. Mich. 1989). Moreover, the *Commercial Credit* ruling (*i.e.* that if the *Complete Auto* requirements are

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Court emphasized that it was a net-income tax[57] (as opposed to a gross receipts tax), that the statute allowed for deduction of taxes paid in other states, and that the taxpayer entity had failed to clearly show what taxes had been levied by other states.

Although the *Commercial Credit* case is not binding on us, we regard its conclusion—that *Complete Auto* is the appropriate analytical framework—as highly persuasive. Here, like in *Commercial Credit,* the Bank, although domiciled in the taxing state and having no out-of-state branches or subsidiaries, was nevertheless "engaged in interstate commerce."[58] By parity of reasoning, we conclude that the *Complete Auto* test controls the Commerce Clause analysis.

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met, a State may tax the entire net income of a domestic entity which conducts all or some of its business out-of-state) was implicitly endorsed in *District of Columbia v. Chase Manhattan Bank,* 689 A.2d 539, 542-43 (D.C. App. 1997).

[57] *See United States Glue Co. v. Oak Creek,* 247 U.S. 321 (1918) (distinguishing between a tax upon gross receipts—more likely to impede or discourage the conduct of commerce—and a tax upon the net income, arising from whatever source, which would be constitutional if there is no discrimination against interstate commerce).

[58] The purpose of the Commerce Clause is not "to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.,* 514 U.S. 175, 182-83 (1995) (citing *Western Live Stock v. Bureau of Revenue,* 303 U.S. 250, 254 (1938)).

2) *Complete Auto's Fair Apportionment Requirement Is Satisfied*

We now reach the Bank's claim that the second prong of *Complete Auto* is not satisfied, because under the Delaware statute the tax is not fairly apportioned. The applicable Delaware bank franchise tax has a two-fold "structural" apportionment mechanism. First, a bank domiciled in Delaware would not be taxed on income attributable to (OTS-authorized) out-of-state branches or subsidiaries, to the extent that other states tax that portion of the income. Second, a bank not domiciled in Delaware would be taxed only on the income attributable to a Delaware branch or subsidiary.

The Bank first contends that, by amending the statute in 2006, the Delaware Legislature "recognized the constitutional infirmities of the existing regime." Under the 2006 amendment, a bank may choose to be taxed under the Section 1101 method (as occurred here) or under an alternative method established in Section 1101(A) (which was not available to the Bank for the tax years at issue). The alternative franchise tax is the sum of two components: (1) a tax on the "entire net income" that is apportioned to the state of Delaware, and (2) a location benefit tax "reflecting the value of utilizing Delaware's banking laws and bank system." The three factors used for apportionment are property, payroll, and receipts.[59]

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[59] *See* 5 *Del. C.* § 1101(A).

We find no merit to the Bank's contention that the 2006 amendment exposes the constitutional infirmity of the pre-amendment scheme. Absent legislative history showing the contrary, a statutory amendment will not be regarded as indicative that the predecessor version was unconstitutional.[60] Here, the legislative history indicates that the purpose of the amendment was "to promote economic development"[61] in Delaware. There is no evidence of any purpose to correct any perceived unconstitutionality of the original version.

Under *Complete Auto's* second prong, a tax is fairly apportioned if it is internally and externally consistent.[62] Nowhere in its briefs does the Bank dispute that the internal consistency test is met. The Superior Court held that the internal consistency test was satisfied because "[i]f every state's franchise tax included mortgage interest only when its banks held the mortgages, there would not be multiple taxation."[63] The Bank does not challenge this determination on appeal.

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[60] *See People v. Regelin,* 443 N.W.2d 436, 438 (C.A. Mich. 1989), where the court found that "reliance on the amendment [of a criminal statute] to support a conclusion that the Legislature recognized a constitutional infirmity in the existing statute" was "arguable."

[61] *See* Synopsis of S.B. 249, 143rd Gen. Assem. (Del. 2006).

[62] *See Container Corp. of Am. v. Franchise Tax Board,* 463 U.S. 159, 169 (1983); *Goldberg v. Sweet,* 488 U.S. 252, 261 (1989).

[63] Super. Ct. Op., at *9.

What the Bank claims is that the tax, as imposed, was not "externally consistent" because it was unapportioned and resulted in multiple taxation. The focus of the external consistency inquiry is upon the economic justification for the state's claim upon the value taxed.[64] That inquiry is whether the "factors used in the apportionment formula . . . actually reflect a reasonable sense of how income is generated."[65] The Bank cites no cases addressing an apportionment system that is similar to that employed by the Delaware statute. The federal cases cited by the Bank[66] merely reiterate the undisputed and well-settled proposition that external consistency mandates that states tax "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[67]

Delaware's apportionment system is "structural." That is, the bank franchise tax statute apportions income according to the banking entity's structure:

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[64] *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[65] *Container Corp.*, 463 U.S. at 169.

[66] *City of Modesto v. National Med., Inc.*, 128 Cal. App. 4th 518 (2005); *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108. 134 (Pa. 2003); *Southern Pacific Transp. Co. Inc. v. State, Dept. of Revenue*, 44 P.3d 1006 (Ariz. Ct. App. 2002); *City of Winchester v. Am. Woodmark Corp.*, 471 S.E.2d 495, 498 (Va. 1996). Those cases analyze various (different) systems of apportionment, or lack thereof.

[67] *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989).

home office, branches, and subsidiaries. Structural apportionment is peculiarly tailored to banks, which are heavily regulated entities. The activities that a bank may conduct are restricted, the places (branches, subsidiaries, agency offices) where a bank may conduct those activities are specified, and both are subject to a detailed system of regulatory accounting and financial control. The Bank argues that Delaware's structural apportionment system is flawed because the only permissible apportionment factor is the source of the income (*i.e.,* where the income was earned), not how the entity is structured or how the income is earned. None of Bank's cited authorities supports its proposition.[68] Apart from the requirement of reasonableness, the United States Supreme Court has expressly declined to impose constitutional constraints on a state's selection of a particular income allocation formula.[69] As the Commissioner observed, states have "wide latitude" in

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[68] The typical apportionment formula used in most states combines three factors: tangible property, payroll and sales. We observe that "tangible property" is an asset, "payroll" is an expense, and only the "sales" factor represents income (more precisely, gross income). If (as the Bank argues) only income—and its source—is an appropriate apportionment factor, then it seemingly follows that the apportionment formula employed by most states is unconstitutional. However, the United States Supreme Court has specifically approved the classical apportionment formula. *See Container Corp.* and *Barclays Bank PLC v. Franchise Tax Bd. of Cal.,* 512 U.S. 298 (1994).

[69] *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 274 (1978) (upholding a single-factor formula).

devising constitutionally sufficient methods of fairly apportioning the income.[70] Delaware's system need not be the only method of apportioning income, nor need it be the "best" method in the view of any particular taxpayer. The Constitution does not require that Delaware conform to the prevailing approach adopted by other states.[71] All that is required is that the system chosen be reasonable. In our view, that requirement is met here.

Taxing the Bank's entire net income "reasonably reflects the in-state component" of its activity, namely, that the funds generated by the Bank's domiciliation in Delaware "fueled [LBH's] entire mortgage banking business."[72] To acquire mortgages, the Bank had two primary funding sources: money generated by certificates of deposit sales and FHLB loans. The Bank held the mortgages purchased with

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[70] Comm. Dec., at p. 14.

[71] In *Container Corp.* and *Barclays Bank,* the United States Supreme Court analyzed California's franchise tax, applied on an entity's "worldwide combined income." The plaintiffs claimed that a "separate accounting" method of apportionment—treating each corporate entity of a multi-state corporation separately for the tax purposes—should be employed rather than the three-factor apportionment classical formula. The Supreme Court upheld the classical formula, noting that California was not required no give up the allocation method chosen, where both methods presented "inescapable imprecision" and both "sometimes result[ed] in double taxation."

[72] Super. Ct. Op., at *9. After LBH acquired the Bank, up to 90% of the funds for LBH's mortgage business came from the Bank. *See* Super. Ct. Op., at *2.

those funds for 45 to 60 days, and the interest accumulated during that period generated almost 100% of the Bank's income.[73] The bank franchise tax is directed to that interest income, and only to that income. As the Superior Court correctly observed, "*Delaware did not tax any other transactions.* It did not tax the Bank's activities outside Delaware, such as Aurora's lending in Colorado. Nor did [Delaware] tax the loans and the interest income after they were moved from Delaware to New York."[74]

With respect to the first source of funding (certificates of deposit), LBH would not have had access to it without the Bank. Only a bank may accept deposits and issue certificates of deposit; therefore, the deposits were accepted at the Bank and the certificates were issued in the Bank's name. These operations all took place in Delaware. Attributing income generated by deposits to the place where a bank has its franchise to operate and is the only location at which deposits are accepted, is reasonable. The Bank's home office was in Wilmington, Delaware. The Bank's sole retail banking office, where all deposits were received, was established and staffed in Wilmington, Delaware. That the Bank had officers

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[73] As one representative of the Bank testified "[W]e sent the money to Delaware because that's where . . . our operating account was. . . . [I]t has to hit the books and records somewhere. It can't really hit your books and records in New York. It has to hit your books and records in the bank."

[74] Super. Ct. Op., at *9 (emphasis added).

and employees at locations other than Wilmington does not weaken Delaware's "reasonable" economic justification for imposing the tax.

Regarding the second source of funding, only the Bank, not LBH, could (and did) receive FHLB loans. By virtue of being a Delaware-based federal savings association, the Bank was able to obtain loans from the Pittsburgh FHLB.

The Bank disputes this conclusion, arguing that LBH would have had access to federally insured deposits and FHLB loans (from Pittsburgh or elsewhere) if it acquired *any* federal savings bank, not necessarily one chartered in Delaware. But, LBH chose to acquire a Delaware bank, and that choice resulted in significant benefits: authorization to lend money outside the state in accordance with Delaware laws without regard to the other states' lending restrictions or usury laws; fire and police protection; access to courts; and access to schools, health care, and welfare benefits for the Bank's employees.[75] Those benefits are "reasonably" related to the Bank's presence in Delaware.

The Bank next urges that the external consistency test is not satisfied because the Delaware bank franchise tax creates both threatened and actual multiple taxation. There is no constitutional prohibition against actual double taxation occasioned by two

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[75] *See* Super. Ct. Op., at *10.

states having different apportionment systems.[76] In any event, the Bank's argument leads nowhere because the Superior Court found that the Bank had failed to prove by "clear and cogent evidence"[77] precisely what income (if any) was taxed by other states. As earlier explained, other than an unsupported one page document purporting to show that $106 million in tax was paid to other jurisdictions, nothing in the record establishes actual multiple taxation or a significant threat thereof. Thus, the external consistency requirement is met here, because the structural apportionment framework of the Delaware bank franchise tax statute reasonably reflects and fairly measures the Delaware components of the Bank's "multi-state" business. Accordingly, Delaware's bank franchise tax does not violate the Dormant Commerce Clause.

B. *Due Process Clause Analysis*

The Bank also challenges the constitutionality of the Delaware bank franchise tax statute under the Due Process Clause of the Fourteenth Amendment.

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[76] *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 277-78 (1978); *Barclays Bank*, 512 U.S. at 318-19 (citing *Container Corp.*, 463 U.S. at 187-89).

[77] *Moorman Mfg.*, 437 U.S. at 274 (1978) ("assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that State,' or has 'led to a grossly distorted result.'") (internal citations omitted).

For a state to constitutionally tax income generated in interstate commerce, the Due Process Clause imposes two requirements: "a 'minimal connection' or 'nexus' between the interstate activities and the taxing state, and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise.'"[78] The Bank argues that Delaware's taxing of all the Bank's income violates Due Process because no rational relationship exists between the tax imposed by Delaware and the income taxed, which, the Bank urges, was earned from activities conducted outside of Delaware.

The United States Supreme Court has held that the requisite nexus between the interstate activities and the taxing state is established if the taxpayer avails itself of the "substantial privilege of carrying on business" within the taxing state.[79] Sufficient connection has been found to exist where the taxpayer maintains an office in the taxing state.[80] Here,

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[78] *Container Corp.*, 463 U.S. at 169 (citing *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 436 (1980)).

[79] *Mobil Oil Corp.*, 445 U.S. at 436 (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444-45 (1940)).

[80] *D.H. Holmes, Ltd. v. McNamara*, 486 U.S. 24, 32 (1988); *Nat'l Geographic v. Cal. Equalization Bd.*, 430 U.S. 551, 556 (1977). Despite their similar language, the nexus requirements of the Due Process and Commerce Clauses are not identical. The Commerce Clause is more stringent than the Due Process Clause on the state's taxation power. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 312-13 (1992). *See also J.C. Penney Nat. Bank v. Johnson*, 19 S.W.3d 831, 836-37 (1999).

it is undisputed that the Bank had the requisite minimum contacts with Delaware: the Bank's home office and the Bank's sole banking office were both located in Wilmington, Delaware. Those contacts are sufficient to satisfy the Due Process minimal connection requirement.

For the second requirement to be satisfied, there must be a rational relationship between the taxed income and the "values connected with the taxing State."[81] The inquiry is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state."[82] The privilege of carrying on a business in the state; police and fire protection; emergency health services; public utilities; and a safe climate to conduct business have been deemed sufficient to support imposition of the tax.[83] The Superior Court held that "the Bank receives many of Delaware's benefits and protection, thus satisfying this requirement."[84] The record discloses no basis to disturb that finding.

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[81] *Moorman Mfg.*, 437 U.S. at 272-73 (citing *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

[82] *J.C. Penney*, 311 U.S. at 444.

[83] *See J.C. Penney*, 311 U.S. at 444; *Bridges v. Autozone Properties, Inc.*, 900 So.2d 784, 809 (La. 2005); *Zelinsky v. Tax Appeals Tribunal of State*, 801 N.E.2d 840, 848 (N.Y. 2003).

[84] Super. Ct. Op., at *11. In so ruling, the trial court observed that Delaware's ability to impose a tax is not affected by the fact that "the mortgages were originated or approved somewhere else nor that the funds for the mortgages came through Pittsburgh." Super. Ct. Op., at *12 (citing *J.C. Penney*,

(Continued on following page)

For these reasons, the Commissioner and the Superior Court correctly concluded that the Delaware bank franchise tax, as applied to the Bank, satisfies the Due Process requirements imposed by the United States Constitution.

Abatement of Penalties

Finally, the Bank claims that the Commissioner erred by refusing to abate the assessed penalties, which, according to the Bank, totaled $14 million and were "excessive compared to the activities conducted in the State." Before reaching the issue of excessiveness, we note that the Bank's computation of the "amount" of penalties as $14 million is factually incorrect.[85] In fact, the penalties total slightly less than $8 million. The $14 million includes the penalties *plus* the additional tax liability. The Commissioner imposed penalties at a daily rate of 0.05% of the additional tax assessed, beginning March 1, 2001 (the due date for the 2000 tax) to May 20, 2005 (the date of the Commissioner's decision). Those penalties

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311 U.S. at 444 (holding that "[t]he fact that the tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction."))

[85] The Superior Court adopted the Bank's incorrect computation: "The Commissioner also assessed late payment penalties amounting to $14,515,474 for 2000-2003, and also another penalty of $5,251.74 for each day after May 20, 2005 that the assessments remain unpaid." *See* Super. Ct. Op., at *3.

totaled approximately $4 million.[86] The Commissioner determined that penalties would accrue at the same rate until the additional tax assessed was paid. Consequently, as of May 23, 2007 (the date of the oral argument before this Court), the aggregate amount of the penalties, exclusive of additional tax, was approximately $7.8 million—not $14 million as the Bank claims.

Turning to the legal merits, the Commissioner assessed penalties under Section 1104(e), which provides that "[i]f any banking organization . . . shall fail to pay any tax due under this chapter on or before the due date, a penalty of 0.05 percent shall be assessed for each day that the same shall remain unpaid after such date."[87] The Commissioner refused to abate the penalties, holding that the amount was appropriate "in relation to the activities [the Bank] conducted and the income it earned in [Delaware]," and was not excessive even though "the review of the Bank's franchise tax returns for the years at issue did not begin until after March 2003."[88] Under Section 1114, the Commissioner "is *authorized* to abate the unpaid portion of the assessment of any tax, interest, penalty, additional amount or addition to the tax, or any liability in respect therefore, which is . . .

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[86] *See* Comm. Dec., pp. 17-21.

[87] 5 *Del. C.* § 1104(e). Chapter 5 contains two other provisions establishing penalties in connection with the bank franchise tax (§ 1104(a) and (c)), which are not applicable here.

[88] Comm. Dec., p. 21.

[e]xcessive in amount."[89] The usage of the word "authorized" indicates that the Commissioner has discretion whether or not to abate. The Internal Revenue Code ("IRC") contains a virtually identical abatement provision,[90] which has been construed as conferring discretionary power to the taxing authority.[91]

In considering whether to exercise that discretionary power, the Commissioner held that the phrase "excessive in amount" should not be given "an expansive meaning that includes some general notion of equitable fairness."[92] Starting from that premise, the Commissioner mechanically applied the statutory percentage rate to the additional tax liability assessed, as of March 1, 2001 (the due date for the 2000 tax). Federal District Courts and the United States Tax Court have held that a taxing authority abuses its discretion if it denies a taxpayer's abatement request "arbitrarily, capriciously, or *without sound*

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[89] 5 *Del. C.* § 1114(a.1) (italics added). Although the Commissioner is authorized to abate both tax assessments and penalties, the Bank is only disputing the Commissioner's refusal to abate the penalties.

[90] *See* I.R.C. § 6404(a)(1). *See also* 30 *Del. C.* § 538 (Chapter 30's abatement provision, virtually identical to the IRC provision).

[91] *See Matter of Bugge,* 99 F.3d 740, 744 (5th Cir. 1996); *Wright v. C.I.R.,* T.C.M. 2004-69, at *2 (U.S. Tax. Ct. 2004).

[92] Comm. Dec., p. 21. *But see Edelson v. C.I.R.,* 829 F.2d 828, 832 n.4 (9th Cir. 1987) (noting that the Commissioner is free to forgive a portion of the tax, should the taxpayers apply for "executive clemency").

basis in fact or law."[93] Here, the record does not disclose any basis in fact for the Commissioner's refusal to abate, because the Commissioner recited no specific facts to support its decision. We recognize that the applicable Delaware statutes (Sections 1104(e) and 1114(a), defining the penalty and, respectively, authorizing abatement) afford little guidance as to the factors to be considered when assessing (and when deciding whether to abate) a bank franchise tax penalty. The counterpart provisions of the IRC and of Chapter 30 (Taxation) of the Delaware Code are instructive in this regard, however.[94]

Both Section 6651(a) of the IRC and Section 534 of Chapter 30 distinguish between penalties for failure to file a return that results in failure to pay the tax, and penalties for failure to pay additional tax

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[93] *Beall v. U.S.*, 335 F.Supp.2d 743, 748 (E.D. Tex. 2004) (emphasis added); *Dadian v. Comm'r*, 2004 WL 1118291 at *3 (U.S. Tax Ct. 2004) (citing *Woodral v. Comm'r*, 112 T.C. 19, 23 (U.S. Tax Ct. 1999)). State courts have also specifically held that a tax authority's refusal to abate penalties may not be arbitrary. *See, e.g., J.M. Smucker, LLC v. Levin*, 865 N.E.2d 866, 869 (Ohio 2007); *Patel v. Director, Div. of Taxation*, 13 N.J. Tax 509, 515 (N.J. Tax. Ct. 1993); *Norris v. Commonwealth*, 625 A.2d 179, 182-83 (Pa. Commw. 1993).

[94] It is proper to look at the general taxation principles contained in the Delaware Code, because several provisions in Chapter 5 (Banking) specifically cross-reference Chapter 30 (Taxation). Moreover, this Court has looked at similar federal tax provisions when a Delaware tax statute was ambiguous. *See Director of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003); *Logan v. Davis*, 191 A.2d 1, 5 (Del. 1963).

assessed following the taxing authority's review of a filed return.[95] Failure to file a return (which did not occur here) results in higher penalties, which are calculated to run from the day that the return should have been filed. In contrast, where a return is filed and additional tax is assessed, a penalty is due only if the taxpayer fails to pay the balance within a prescribed period of time from the assessment.[96]

Here, the Commissioner assessed penalties at a daily rate of 0.05% per day, running from March 1, 2001, when the 2000 bank franchise tax first became due. To assess penalties from March 2001, in a case where no additional tax liability was assessed until October 2003, appears arbitrary.[97] The Commissioner insists that it was not required to notify the Bank of the deficiency any sooner than it did, because the statute contains a three year period of limitations,

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[95] *See* I.R.C. § 6651(a) and 30 *Del. C.* § 534.

[96] Regrettably, 5 *Del. C.* § 1104(e) makes no such distinction.

[97] The Commissioner imposed penalties from the due date of the tax for each year in question, not from the date of the notice of assessment. That computation finds no support in Chapter 30 or the IRC, which provide that, where additional tax is imposed, both penalties and interest may be imposed, but only *from the date of the notice of the proposed assessment* and only if the additional tax assessed is not paid within a certain period of time following that notice. *See* 30 *Del. C.* §§ 533 and 534 and I.R.C. §§ 6601 and 6651. We note that only "penalties" may be imposed under Chapter 5 because Chapter 5 does not mention "interest." The Commissioner, therefore, correctly did not assess interest.

which was observed.[98] But the statute of limitations is not the only factor informing the sound exercise of discretion. 30 *Del. C.* § 521(a) directs that *"[a]s soon as practicable* after any return is filed, the [tax authority] shall examine it to determine the correct amount of tax."[99] Here, the Commissioner's office did not object to the Bank's 2000 Franchise Tax Return until nearly three years after that return was filed. Indeed, not until the Commissioner's October 6, 2003 letter was the Bank told that its Returns for the tax years 2000-2002 were incorrect. Only at that time was the Bank's liability recalculated based on the disallowance of the line 4(b) deduction.

The Commissioner rejected without explanation the Bank's contention that the three year administrative delay justified an abatement of penalties. Before this Court, the Commissioner claims that the delay was attributable to the Bank's failure to submit the requested documentation in support of the line 4(b) deduction. That argument is flawed. The Bank did provide certain apportionment schedules, and the Commissioner and the Superior Court found that those schedules were insufficient to support a line 4(b) deduction. But, during oral argument before this Court, the Commissioner conceded that the submission of *any* documentation, however sufficient, would have been "irrelevant," because the line

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[98] *See* 5 *Del. C.* § 1111.

[99] 30 *Del. C.* § 521(a) (emphasis added).

4(b) deduction was simply not available to the Bank as a matter of law.[100] Accordingly, for penalty abatement purposes, the Commissioner may not rely on the Bank's failure to provide sufficient supporting documentation.

Finally, Chapter 30 and the IRC provide that penalties should not be imposed when the failure to pay the additional tax liability assessed is "due to reasonable cause and not due to willful neglect."[101] The United States Supreme Court held that "reasonable cause" exists where a taxpayer demonstrates that it exercised "ordinary business care and prudence," and that "willful neglect" means "conscious, intentional failure or reckless indifference."[102] Although it is for the Commissioner, not this Court, to determine whether the Bank met these requirements, it is noteworthy that: (i) the Bank filed its original Franchise Tax Returns consistent with the practice of its predecessor; (ii) the timeliness of the Bank's filings is undisputed; (iii) the Bank requested, and relied upon, the opinion of an independent tax advisor (Ernst & Young) before amending its returns in August 2004; (iv) the Bank later obtained the opinion

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[100] As explained above, that deduction applies solely to entities that have out-of-state branches or subsidiaries. The Bank had no such branches or subsidiaries during the relevant period.

[101] *See* I.R.C. § 6651(a)(3) and 30 *Del. C.* § 534(b)(2).

[102] *Director of Revenue v. J.E. Rhoads & Sons, Inc.*, 628 A.2d 1388, 1390 (Del. 1993) (citing *United States v. Boyle*, 469 U.S. 241, 245-46 (1985).

of a second independent tax advisor (PricewaterhouseCoopers); (v) the Bank contested in good faith the assessment of additional tax liability, before the Commissioner, the Superior Court, and this Court; and (vi) the Bank's legal position with respect to the original and the amended Franchise Tax Returns was not frivolous, and the filing of those Tax Returns was not fraudulent.

Because the Commissioner failed to consider any of the above-described circumstances, we are constrained to conclude that the Commissioner abused its discretion by refusing to abate, in an appropriate way, the penalties assessed. It follows that, in affirming the Commissioner's decision, the Superior Court legally erred. Therefore, the penalty provision of the Superior Court order will be reversed, and the case will be remanded with instructions that the Superior Court remand the case to the Commissioner to reconsider the Bank's request for abatement of penalties, in accordance with this Opinion.

CONCLUSION

For the reasons set forth, the judgment of the Superior Court is affirmed in part, and reversed in part and remanded.

APPENDIX C

IN THE SUPERIOR COURT OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

LEHMAN BROTHERS BANK, FSB,	)	
Appellee,	)	
v.	)	C.A. No. 05A-06-004-FSS
STATE BANK COMMISSIONER,	)	
Appellant,	)	

Submitted: August 28, 2006
Decided: November 30, 2006

OPINION and ORDER

Upon Appeal From the State Bank Commissioner's Decision – *AFFIRMED*

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SILVERMAN, J.

This is an appeal from a decision by the State Bank Commissioner upholding a tax assessment and penalties imposed under the bank franchise tax. The appellant, a federal bank chartered in Delaware, challenges the tax's applicability, as most of the Bank's employees, especially its senior management, work in New York. Alternatively, the Bank contends that the tax violates federal Commerce and Due Process Clauses.

A common thread running through the Bank's argument is its insistence that it is a multi-state operation and Delaware taxed all of its operations, regardless of where they happened. Thus, the Bank repeatedly accuses Delaware of overreaching. That argument exaggerates what Delaware taxed. The bank franchise tax covers all the Bank's business activities relating to the mortgages, but only while the mortgages were on the Bank's books here. Delaware, for example, did not tax the Bank's activities through Aurora in Colorado, the decision-making in New York or the interest earned while the mortgages were in New York.

I.

Although the parties disagree about their legal significance, they basically agree about the facts. As discussed in the Commissioner's decision and presented below, Lehman Brothers Holdings, Inc., has operated a mortgage business since the 1980s. LBH's executive office and senior management were in New

York. LBH bought or acquired mortgages issued by independent mortgage lenders and brokers, or by its subsidiary mortgage company, Aurora Loan Services, Inc. LBH did not deal directly with the borrowers. Before 1999, LBH's mortgage business was funded by unsecured bank loans, commercial paper, or short and long-term repurchase agreements. This funding was unstable since the markets could collapse, causing a financial crisis for LBH. Due to this instability, for several years LBH actively sought a federal savings bank. Through a federal savings bank, LBH would gain access to Federal Home Loan Bank funds. FHLB funding is more stable and efficient than market funding. Also, a FHLB would lend more money on the dollar, up to 70%.

Around July 1, 1999, LBH acquired Delaware Savings Bank, FSB, changing the Bank's name to Lehman Brothers Bank, FSB. The Bank's Federal Stock Charter became effective on June 30, 1999, making the Bank a federally chartered savings bank, organized under the Federal Home Owner's Loan Act, Section 5. Being organized under HOLA, the Bank was subject to regulation and supervision by the United States Office of Thrift Supervision. Also, a federal charter gave the Bank access to the FHLB, which gave the Bank the ready source of funds LBH wanted. For the tax years in question, 2000-2003, the Bank's home office, designated in its federal charter, was Wilmington, Delaware, and the Bank's sole retail banking office was in Wilmington. Delaware's home

office designation meant that the Bank could access funds through the FHLB in Pittsburgh.

As stated in the record, the Bank's income came primarily from the mortgage banking business, but the Bank did have an unprofitable retail banking office for personal banking, including savings and checking accounts. As provided above, LBH primarily used the Bank to obtain federal funds and buy mortgages.

To fund mortgages, the Bank had two primary sources: money generated by CD sales and loans made by the FHLB in Pittsburgh. Since only a bank can accept deposits and issue CDs, the CDs were issued in the Bank's name and deposited at the Bank. Also, the Bank, not LBH, could receive loans from the FHLB. Therefore without the Bank, LBH would not have had access to FHLB loans nor be could it issue CDs. After LBH acquired the Bank, up to 90% of the funds for its mortgage business came from the Bank. Of this 90%, 25-30% came from the CDs, and 50-60% from the FHLB loans.

Using the FHLB loans and proceeds from CD sales, the Bank obtained mortgages from three sources. The Bank obtained some mortgages by buying residential mortgage pools. The Bank would buy a group of these mortgages that were already issued and funded.

Alternatively, the Bank originated mortgage loans directly, either through a broker or correspondent channel. With a broker, a borrower who wanted

a mortgage would go to LBH's subsidiary, Aurora. Aurora, under the Bank's guidelines, would review the loan and approve the borrower's credit and the mortgage. Aurora's services usually took place in Colorado. For an Aurora mortgage settlement, the Bank, through its funding desk in New York, would wire the funds to Aurora. The funds came to the funding desk from the Bank in Delaware through CDs and FHLB funds, as explained above. These mortgages were funded by the Delaware Bank and in the Bank's name. Therefore, the Bank held these mortgages.

Otherwise, when the Bank bought a mortgage through a correspondent channel, another lender would underwrite and fund the loan. The lender held that mortgage. Then, the lender would sell the mortgage to the Bank, through Aurora. Again, the Bank would then hold the mortgage.

In all three situations, the Bank held the mortgages in Delaware. Normally, the Bank would keep the mortgages for 45-60 days, with the mortgages staying on the books in Delaware, generating interest income for the Bank. As the Bank's representative testified:

> [W]e sent the money to Delaware because that's where our main operating – that's where our operating account was. . . . [I]t has to hit the books and records somewhere. It can't really hit your books and records in New York. It has to hit your books and records in the bank.

During these 45-60 days, the Bank received about 4% in interest income, amounting to millions of dollars. According to the Bank, this interest income comprised 97-98% of the Bank's total income. The Bank then "sold" the mortgages to LBH, realizing no profit on the transfer. As discussed below, LBH is challenging the tax Delaware indirectly imposed on the income earned by the Bank while the mortgages were held in Delaware.

As mentioned, however, most of the Bank's management was located in New York. To conduct the mortgage banking business, 20-25 full-time employees and 66 "dual employees" were in New York. These "dual employees" held positions with the Bank, and the Bank reimbursed LBH for their services. Also, the Bank had 24 "dual employees" in Colorado who were on Aurora's payroll. These Colorado employees followed the Bank's guidelines when approving mortgages, and the Bank reimbursed Aurora for these employees' services.

II.

For each year at issue, the Bank filed a franchise tax report. For the years 2000-2002, the Bank filed under 5 *Del. C.* § 1101(a),[1] as a banking organization with its principal place of business in Delaware. The Bank claimed a 50% income deduction on

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[1] "A franchise tax is hereby imposed on the "taxable income" of banking organizations and trust companies. . . ."

its franchise tax report, using a line 4(b) deduction. Line 4(b) allows a banking organization to deduct "[n]et operating income before taxes verifiable by documentary evidence from any . . . branch within the United States pursuant to § 771 of Title 5 . . . , which is derived from business activities carried on outside the State and subject to income taxation under the laws of another state. . . ." The Bank, however, failed to provide the "documentary evidence" specified in 5 *Del. C.* § 1101(a)(1).

In 2002, the Commissioner requested the required documentation. After repeated requests with no response, the Commissioner finally notified the Bank that its 2000-2002 tax returns were deficient and recalculated the Bank's tax liability, without the line 4(b) deduction. The Commissioner computed the Bank's franchise tax assessments, not including penalties as:

- $3,209,996 for 2000;
- $4,936,270 for 2001;
- $7,715,354 for 2002; and
- $11,577,586 for 2003.

The Commissioner also assessed late payment penalties amounting to $14,515,474 for 2000-2003, and also another penalty of $5,251.74 for each day after May 20, 2005 that the assessments remain unpaid.

The Bank disputed the assessment, and the Commissioner sent a notice initiating a proceeding to

determine the Bank's franchise tax for 2000-2002.[2] Meanwhile, the Bank filed its 2003 tax return without claiming a 4(b) deduction. Instead, the Bank reported dramatically less income than the previous years, relying on 5 *Del. C.* § 1101(b).[3] The Commissioner then sent the Bank another notice initiating proceedings, this time to determine tax liability for the 2003 tax year.

In September 2004, the Bank recomputed the franchise tax owed for the years at issue, based on amended reports prepared by its accountants, Ernst & Young, LLP. And, the Bank asked for refunds. These amended returns were prepared on the premise that the Bank was not headquartered in Delaware but instead should be treated as a branch. The Commissioner initially rejected the recalculations and denied refunds. At the Bank's request, an evidentiary hearing on all the assessments was held on September 30, 2004, before the Commissioner.

In his decision, dated May 20, 2005, the Commissioner upheld the deficiencies and penalties, and he further found that the franchise tax did not violate Delaware law, and the federal Commerce or Due

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[2] 29 *Del. C.* § 10122 ("Whenever an agency proposes to proceed for a case decision, it shall give 20 days' prior notice to all parties. . . .").

[3] "A franchise tax is hereby imposed on the 'taxable income' of federal savings banks not headquartered in this State but maintaining branches in this State, verifiable by documentary evidence."

Process Clauses. On June 10, 2005, the Bank filed a timely Notice of Appeal with this court. The Bank does not challenge the administrative proceedings' procedural correctness.

III. Standard of Review

This is on appeal from the State Bank Commissioner's Decision. The Commissioner's factual findings will be upheld if they are supported by substantial evidence.[4] Questions of law are reviewed *de novo*.[5] In other words, the court will apply the facts as the Commissioner found them to be, to the law as the court finds it to be, and in that way decide the appeal.

IV. Delaware's Franchise Tax

The Bank vehemently argues that it is not a Delaware domiciliary, as it is federally chartered, and therefore, neither legally nor commercially domiciled in the state. Instead, the Bank contends that it is headquartered, and also commercially domiciled, in New York, meaning that the Bank would pay less franchise taxes. Alternatively, the Bank contends its

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[4] 29 *Del. C.* 10142(d). *See also Public Water Supply Co. v. DiPasquale*, 735 A.2d 378, 380-81 (Del. 1999).

[5] *Bd. of Educ. of Smyrna School Dist. v. DiNunzio*, 602 A.2d 85, 93 (Del. 1990). *See also State Dept. of Correction v. Worsham*, 683 A.2d 1104, 1106 (Del. 1994); *Public Water*, 735 A.2d at 380-81.

mortgage activity was conducted outside Delaware, and therefore, Delaware cannot include this out-of-state activity when computing the bank franchise tax.

A franchise tax generally is a tax on an entity for the right or privilege of doing business or exercising its franchise in a state.[6] While it is a tax on doing business, the tax is based on the "taxable income" of corporations or banking organizations doing business in the state.[7] Franchise taxes "are not placed upon a particular corporate business or transaction, but upon the privilege of doing business as a corporation and exercising corporate powers for the purpose of producing a profit."[8] "The term 'doing business' is not uniformly defined in the cases, and its meaning will vary dependent on the situation."[9]

A franchise tax is different from other taxes, including income taxes, as it is imposed for different

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[6] *Pacific Co. v. Johnson*, 285 U.S. 480, 501 (1932). *See also Martin v. Producers Pipe Line Co.*, 113 F.2d 817, 818 (6th Cir. 1940).

[7] 5 *Del. C.* § 1101.

[8] *Broadmoor-Kingsport Apartments, Inc. v. State*, 686 S.W.2d 70, 72 (Tenn. 1985). Although this case deals with a corporate franchise tax, the statute included banks and was also for the privilege of doing business in the state, as is the case here. T.C.A. § 67-4-903 (1985) states, "All corporations . . . doing business in Tennessee, including state chartered banks and national banks doing business in Tennessee shall, without exception other than as provided herein, pay to the commissioner of revenue, annually a privilege tax."

[9] *Id.*

purposes. "The [franchise] tax is not laid on property or on income, though both are regarded in measuring it."[10] A state can tax the entity's income and also impose a franchise tax since "income taxes are based on taxing individuals and entities on monies made whereas franchise taxes stem from the notion that a company should pay for the privilege of operating its business in this state."[11] Therefore, a franchise tax is still constitutional even if it taxes property that was already subjected to taxation.[12]

In Delaware, a bank franchise tax is "imposed on the 'taxable income' of a banking organization."[13] In its Post-Hearing Reply Brief, the Bank argues that it was not a banking organization.[14] On appeal, however, the Bank no longer disputes that it is a banking organization for franchise tax purposes, and therefore, it must pay the franchise tax.[15] Under Delaware's bank franchise tax, the taxation method depends on whether the banking organization is headquartered in Delaware.[16] Under §§ 101(4)(b) and

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[10] *Southern Realty Corp. v. McCallum*, 65 F.2d 934, 935 (5th Cir. 1933).

[11] *Miss. State Tax Com'n v. Chevron U.S.A., Inc.*, 650 So.2d 1353, 1355-56 (Miss. 1995). *See also Bass*, 266 U.S. at 280.

[12] *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271, 280 (1924).

[13] 5 *Del. C.* § 1101(a).

[14] Appellant's Post-Hearing Reply Brief at 13.

[15] *See* 5 *Del. C.* § 101(17) and 7 *Del. C.* § 101.

[16] 5 *Del. C.* § 1101(a)-(b).

1101(a), a bank whose "principal office" is based in Delaware is taxed on all taxable income, except the bank may exclude income earned from activities conducted outside Delaware by branches or subsidiaries subject to tax outside Delaware.[17] If the bank is not "headquartered" in Delaware, if it is an out-of-state bank with a branch in Delaware, it is still subject to a franchise tax, but to a limited extent.[18] For an out-of-state bank, the franchise tax is only imposed on the income from that branch in Delaware.[19] The code, though, does not define "headquartered" or "principal office."

A. Headquarters

Relying on the fact that the Bank is chartered in Delaware and its home office is here, the Commissioner found that the Bank is headquartered in Delaware for franchise tax purposes. The Bank, however, draws a distinction between its home office and headquarters. Because the Bank's senior management is New York-based and some mortgage decisions come from there, the Bank concludes that the Commissioner was legally bound to hold that the Bank was headquartered in New York for franchise tax purposes.

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[17] 5 *Del. C.* §§ 101(4)(b), 1101(a).

[18] 5 *Del. C.* § 1101(a)-(b).

[19] *Id.*

Also, the Bank urges the court to look to the Uniform Division of Income for Tax Purposes, a model law, which defines commercial domicile as the "principal place from which the trade or business of the taxpayer is directed or managed," and the Multistate Tax Commission Regulation, another model law, which defines commercial domicile as "the place from which the trade or business is principally managed or directed."[20] As the Commissioner found, both arguments are flawed. First, Delaware has never adopted UDITPA, although it has been around for years. Second, Delaware is not a MTC member. Therefore, neither UDITPA nor MTC is controlling.

The Bank further argues that the Commissioner should look to the definition of commercial domicile provided in 30 *Del. C.* § 1901(2), which is identical to the UDITPA's definition. This also is unpersuasive. Thirty *Del. C.* § 1901(2) deals with corporate income tax, not a bank franchise tax. Also, commercial domicile is never mentioned in 5 *Del. C.* § 1101.

Meanwhile, four reasons support the Commissioner's finding that the Bank is headquartered in Delaware for franchise tax purposes. First, as a general matter, there may be several ways to characterize the Bank as an entity. Under the statute, however, there are only two possibilities: the bank is either headquartered in Delaware or the bank is located out-of-state with a branch in Delaware. For

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[20] UDITPA § 1(b) and MTC Regulation § 2(c)(1)

franchise tax purposes, the Bank simply cannot be a branch. At times the Bank calls itself a branch, yet it fails to show, with supporting documents, that it is a branch as defined in 5 *Del. C.* § 1101.

The Commissioner correctly held that to be a branch, a bank must apply and be approved by authority of the State Bank Commissioner.[21] As noted in the record, the Bank has not received such authority.[22] Therefore, by negative inference, the Bank must have been headquartered in Delaware as it clearly was not a branch. That conclusion is also consistent with how the Bank operated. No banking took place in New York. It cannot be that the Delaware entity was a branch bank.

Second, under 12 C.F.R. § 545.91(a), which governs the Bank, "[a]ll operations of a Federal savings association are subject to direction from the home office." If there is a change in the home office's address, the Federal savings association must apply to the OTS Regional Office.[23] Furthermore, "the principal place of business of an institution is the state in which the institution maintains its home office."[24] Although these federal definitions are not dispositive,

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[21] 5 *Del. C.* §§ 770(a)(1), 771(a).

[22] The Bank once had a Delaware branch, which closed in 2000. Also, in 2003, the Bank received authority to open a branch in Jersey City, New Jersey.

[23] 12 C.F.R. § 545.91(b).

[24] 12 C.F.R. § 925.18(b).

Delaware's Supreme Court has used federal definitions when a Delaware statute did not clearly define a term.[25] The record shows that the Bank's federal stock charter designates Wilmington, Delaware as the home office, and the Bank has never applied to change this status.

Third, a federal savings bank "may become a member only of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business. . . ."[26] Here, the Bank's principal place of business in Delaware allowed LBH access to the FHLB in Pittsburgh. The FHLB in Pittsburgh does not serve New York. Therefore, it is understood that the FHLB in Pittsburgh could only serve the Bank if the Bank's place of business was in Delaware, not New York.

Fourth, as the Commissioner held, he has traditionally "deferred to the bank's federal chartering authority to determine the location of the bank's principal office for franchise tax purposes." This is based on 5 *Del. C.* § 801(5), which states that a bank is located in the State if the "organization certificate identifies an address in this State as the place at which its discount and deposit operations are to be carried out." This definition is cross-referenced in the

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[25] *Dir. of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003).

[26] 12 U.S.C. § 1424(b).

franchise tax provisions.[27] The Bank's charter designates Wilmington as its home office. Therefore, the Commissioner correctly concluded that the Bank is headquartered in Delaware for franchise tax purposes.

B. Taxable Income

Although the Bank dwells on "domicile," "headquarters" and "principal place of business," it ignores the fact that all its income was actually earned in and derived from sources in Delaware. Even if the Bank were not headquartered in Delaware for franchise tax purposes, which it is, the Bank actually earned the money in Delaware. That means the income is still included in the Bank's "taxable income." For income tax purposes, there are two basic ways a state can tax: a state can tax a person or entity domiciled in the state, even on income earned outside the jurisdiction, or the state may tax nonresidents on their income derived from sources within the state.[28] Although a franchise tax is different from an income tax, the franchise tax in Delaware is calculated based on a bank's "taxable income." If Delaware could tax the income, then that income can be included in calculating the franchise tax. So, "taxable income" includes all income derived from sources in the state.

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[27] 5 *Del. C.* § 1101(a)(1)(b.2).

[28] *Shaffer v. Carter*, 252 U.S. 37, 57 (1920).

The Commissioner relied on two important facts when deciding that the income was earned in Delaware. First, the Bank actually received the interest income in Delaware, as that is where the income "hit the books." Second, the Bank obtained the funds used to generate the income through Delaware. Those funds included the money from CD sales and the FHLB loans. Without the funds from Delaware, the Bank and LBH could not have produced the income. Further, the Commissioner made it clear that after the Bank "sold" the mortgages to New York, he did not include any of the New York interest income in the franchise tax assessment. Thus, Delaware only taxed income the Bank earned in Delaware.

The Bank continually focuses on where the decisions were made and where the employees were located to reach the conclusion that none of its activities took place in Delaware. The Bank, though, tries to minimize Delaware's involvement. While the Bank emphasizes the employee's location and payroll, these employees were on the Bank's books and funded through Delaware. Ultimately, they were paid by the Bank in Delaware. The Bank also de-emphasizes the fact that the interest income was earned at the Bank in Delaware.

The lynchpin of the Commissioner's decision is the fact that the Delaware tax is only imposed on interest income earned in Delaware. In computing the franchise tax, Delaware did not include other transactions, e.g. when the mortgages were purchased outside Delaware or any interest earned after

their transfer to LBH in New York.[29] As described above, what is done within the state's own borders can be taxed.[30] Here, Delaware only taxed what happened within the state. Delaware taxed the mortgage interest, for franchise tax purposes, only when the mortgages were held by and on the books at the Delaware Bank. Also, the funds used to purchase the mortgages came from the Bank. The Bank marshaled the FHLB funding received in Delaware with money earned from the CD sales in Delaware and channeled it to the borrowers. Therefore, the taxed income was earned in Delaware.

As the Commissioner determined the tax was only on activities that occurred in Delaware, it was unnecessary to determine where the Bank is domiciled. But if the case turned on the Bank's domicile, there is much to commend Delaware as the Bank's domicile. The Bank kept its home and its most valuable properly in Delaware, as discussed above.

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[29] Transcript of hearing pgs. 40-41. Answers by Mr. Slomka, the Bank's CEO: "And so as I said, it's about 45 to 60 days on average of the loans we have sitting in our portfolio . . . We earn our approximate 4 percent net interest margin on them during that time and then sell them over to the holding company.

> Q: Is it the interest on the mortgages held for that 45-day period that comprises the bulk of the income of the bank?
>
> A: That's correct."

[30] *Stephan v. State Tax* Comm'r, 245 A.2d 552, 554 (Del. 1968); Guaranty *Trust Co. of N.Y. v. Com. of Virginia,* 305 U.S. 19, 23 (1938).

V. Constitutional Arguments

The Bank also argues that Delaware cannot tax all the Bank's interest income, as doing so violates the Commerce and Due Process Clauses. Under the former, the Bank's only takes issue with one prong of the analysis, described below. The Bank contends that the tax is not fairly apportioned. Under the Due Process Clause, the Bank argues no rational relationship exists between the tax and the income. Under both clauses, the argument is that the Bank "earned nearly all of its income from activities conducted entirely outside of Delaware, principally from its mortgage banking activities conducted in New York," and therefore, Delaware cannot tax the interest income.

When reviewing a statute, the court presumes the statute is valid unless it clearly contravenes a constitutional provision.[31] A strong presumption for validity exists for state taxing statutes.[32] Additionally, tax assessments by the proper taxing authority are considered presumptively valid.[33] "[I]t is to be

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[31] *McClelland v. Mayor and Council of Wilmington,* 159 A.2d 596, 601 (Del.Ch. 1960). *See also State v. Wickenhoefer,* 64 A. 273, 276-77 (Del. 1906); *Davies Warehouse Co. v. Bowles,* 321 U.S. 144, 153 (1944); *Pacific States Box & Basket Co. v. White,* 296 U.S. 176, 185 (1935).

[32] *Kunkel's Estate v. U.S.,* 689 F.2d 408, 424 (3rd Cir. 1982). *See also Estate of Kunze v. C.I.R.,* 233 F.3d 948, (7th Cir. 2000).

[33] *Delaware Racing Ass'n v. McMahon,* 340 A.2d 837, 840 (Del. 1975). *See also In re AWB Associates, G.P.,* 144 B.R. 270 (E.D. Pa. 1992).

presumed that governmental authority has been exercised correctly and in accordance with the law."[34]

The challenger then has the heavy burden to overcome these presumptions.[35] Under both the Commerce and Due Process Clauses, when a state has chosen an apportionment method, an objecting taxpayer has the burden to demonstrate by "'clear and cogent evidence,' that 'the income attributed to the State is in fact out of all appropriate proportions to the business transacted . . . in that State, or has led to a grossly distorted result.'"[36] Also, if two states are taxing the income, a taxpayer has to show that this state is the one that was at fault in the constitutional sense.[37]

The Commissioner found, after looking at each argument, that the Bank did not meet its burden of proof. First, the Bank failed to prepare a separate Delaware balance sheet accounting for the money earned in Delaware. For example, the Commissioner found that the Bank "did not consider the interest that the home office should charge to the mortgage operation because the home office was the source of deposit funds . . . and FHLB borrowings."

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[34] *Id.*

[35] *CNA Holdings*, 818 A.2d at 959.

[36] *Oklahoma Tax*, 514 U.S. at 195 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978)).

[37] *Moorman*, 437 U.S. at 267-68.

Second, the Bank failed to demonstrate exactly what was allegedly being taxed in other states. The Bank argues that the franchise tax subjects the Bank to multiple taxation, but fails to show how. The Bank, through PricewaterhouseCooper's Separate Accounting Review, establishes that it is paying taxes in other jurisdictions, but does not lay out the kind of tax is being imposed. For example, the Bank does not say whether the other states taxed the same mortgage interest income or if they taxed other transactions, such as an origination fee or transfer fee.

Different states taxing different transactions is constitutional.[38] For example, a property tax and income tax on the same corporate property is not double taxation.[39] Similarly, a franchise tax and income tax on the same property is also not double taxation.[40] Therefore, if the other states imposed an income tax, as opposed to a franchise tax, the franchise tax is valid. Nothing in the record reveals that Delaware is taxing the same thing that another state is taxing. The Bank also failed to prove that Delaware was at fault for any duplicative tax.[41] Thus, the

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[38] *Indian Motorcycle Co. v. U.S.*, 283 U.S. 570, 574 (1931).

[39] *State of Tennessee v. Whitworth*, 117 U.S. 129, 135-37 (1886).

[40] *Mississippi State Tax Com'n v. Chevron U.S.A., Inc.*, 650 So.2d 1353, 1355 (Miss. 1995).

[41] *See, e.g., Oklahoma Tax*, 514 U.S. at 195-96 and *Moorman*, 437 U.S. at 277.

Bank has not met its burden to show that the tax is constitutional.

A. Commerce Clause

The Commerce Clause, Article I, § 8, clause 3, expressly authorizes Congress to "regulate Commerce . . . among the several States." Although this is an "affirmative grant of power," the Supreme Court has consistently held that the Commerce Clause contains a negative implication, known as the dormant Commerce Clause.[42] Concerned with the national economy, the dormant Commerce Clause prohibits certain state actions that interfere with interstate commerce.[43]

Some state taxes impermissibly interfere with interstate commerce, and therefore encroach on the regulatory authority granted by Congress.[44] The Supreme Court, however, has repeatedly held that the Commerce Clause's purpose is not to "relieve those engaged in interstate commerce from their just share of state tax burden. . . ."[45] Therefore, state taxation is only prohibited when it imposes a burden

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[42] *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-180 (1995).

[43] *South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177, 185 (1938).

[44] *Oklahoma Tax*, 514 U.S. at 179-80.

[45] *Id.* at 182 (quoting *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

on interstate commerce.[46] A burden exists if the tax subjects interstate commerce to an unreasonable risk of multiple taxation.[47] Even so, some duplicative taxes are tolerable because all states do not follow identical taxation methods.[48] Simply because some duplicative taxes exist does not, by itself, render a state's tax unconstitutional.[49]

Again, when challenging a statute, the taxpayer carries the burden. Not only must the taxpayer prove that the tax is unconstitutional, but also must show that this state is the one at fault. To determine a statute's constitutionality under the dormant Commerce Clause, the Supreme Court has consistently applied the *Complete Auto,* four-part test.[50] This test upholds a tax as long as it is "[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[51] The parties agree that *Complete Auto* controls here.

As mentioned above, the Bank contends that the bank franchise tax violates the Commerce Clause

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[46] *Quill,* 504 U.S. at 309-10.

[47] *Moorman,* 437 U.S. at 288.

[48] *Id.* at 278.

[49] *Id.*

[50] *Oklahoma Tax,* 514 U.S. at 182.

[51] *Quill,* 504 U.S. at 311 (citing *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977)).

because the tax is not fairly apportioned. The Bank insists that Delaware cannot tax 100% of the Bank's income, since none of its income generating activities occurred in Delaware. Also, by taxing all the Bank's income, the Bank contends that Delaware is subjecting the Bank to multiple taxation.

1. Substantial Nexus

Under the *Complete Auto* test's first prong, a substantial nexus must exist with the taxing state.[52] The Commerce Clause's nexus requirement can be met if the taxpayer has physical presence in the state.[53] This prong is also satisfied if the taxpayer conducts activities in the taxing state that "substantially contributed to the taxpayer's ability to maintain operations in the taxing state."[54]

The Bank does not deny its nexus to Delaware, even for Commerce Clause purposes, since the Bank is physically present here. Also, the Bank's Delaware activities, such as accepting CD deposits and accessing FHLB loans, substantially furthered the Bank's mortgage business, contributing over 90% of the funds for it.

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[52] *Id.*

[53] *Id.* at 312.

[54] *J.C. Penney Nat. Bank v. Johnson*, 19 S.W.3d 831, (Tenn. Ct. App. 1999) (citing *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 250-51 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207, 210-12 (1960)).

2. Fair Apportionment

In analyzing *Complete Auto's* second prong, the court determines "whether a tax is fairly apportioned by examining whether it is internally and externally consistent."[55] As mentioned, this is the one prong challenged by the Bank. For internal consistency, the tax must be such that if applied by every jurisdiction, there would not be multiple taxation.[56] "Thus, the internal consistency test focuses on the text of the challenged statute and hypothesizes a situation where other States have passed an identical statute."[57] If every state's franchise tax included mortgage interest only when its banks held the mortgages, there would not be multiple taxation. Therefore, the internal consistency test is met.

"The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[58] "The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity

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[55] *Goldberg v. Sweet,* 488 U.S. 252, 261 (1989).

[56] *Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159, 169 (1983).

[57] *Goldberg,* 488 U.S. at 261.

[58] *Container Corp.,* 463 U.S. at 169.

being taxed."[59] External consistency looks at the economic justification for the state's claim upon the value taxed.[60]

Again, a state is allowed to impose a tax on what happens within its borders.[61] And as mentioned above, Delaware only imposed its franchise tax on the income received in Delaware, when the interest income is on the books here. This income is attributable to Delaware since the funds from the Bank "fueled the entire mortgage banking business." Without these funds, the Bank could not buy the mortgages. And, it was the Bank that bought the mortgages. (It does not matter that someone else, LBH, told the Bank which mortgages to buy.) Then, the Bank earned money from them while they were here. Delaware did not tax any other transactions. It did not tax the Bank's activities outside Delaware, such as Aurora's lending in Colorado. Nor did it tax the loans and the interest income after they were moved from Delaware to New York.

Also, the Commissioner's bank franchise tax assessment is fairly apportioned because, as mentioned, an in-state bank can deduct business done outside the state,[62] and an out-of-state bank can

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[59] *Goldberg,* 488 U.S. at 262 (citing *Container Corp.*, 463 U.S. at 169-70).

[60] *Oklahoma Tax,* 514 U.S. at 185.

[61] *Guaranty Trust,* 305 U.S. at 23.

[62] 5 *Del. C.* 1101(a).

deduct income from out-of-state branches, as long as it submits documentation to support that deduction.[63] Thus, to the extent that income is earned in a branch outside of Delaware and subject to tax in another state, it is not included in calculating Delaware's franchise tax.[64] This is a separate accounting method that taxes only what happens within the state. In other words, this method "taxes corporations that operate within its borders only on the income those corporations recognize on their own books."[65] This separate accounting method has been upheld as constitutional.[66] That is exactly what is happening here. Delaware only taxed income that the Bank recognized on its books.

Additionally, as mentioned above, the Bank did not meet its burden to show that the tax is unfairly apportioned. Although the Bank did show the Commissioner that it was paying taxes in other jurisdictions, the Bank failed to show exactly what was being taxed elsewhere. This is not enough to overcome the tax statutes's strong presumption of validity.

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[63] 5 *Del. C.* 1101(b).

[64] *Id.*

[65] *Id.*

[66] *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 305 (1994).

3. Non-Discriminatory

Under *Complete Auto's* third prong, the state cannot discriminate against interstate commerce by providing a direct commercial advantage to local business.[67] Unconstitutional discrimination typically occurs when a state taxes in-state transactions differently than out-of-state transactions.[68] The Bank does not claim the statute is discriminatory, as the tax treats the Bank like a local business. Moreover, federal law permits a state to tax a federal savings bank or national bank the same as in-state banks.[69] The Bank admittedly is taxed exactly the same as a state chartered bank.

4. Fair Relationship

The *Complete Auto* test's fourth prong requires a fair relation between a tax and benefits, which means that the taxpayer has to "contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct 'benefit.'"[70] This means "that the measure of the tax be reasonably related to the taxpayer's presence or

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[67] *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

[68] *Id.*

[69] 12 U.S.C. § 548 and § 1464(h).

[70] *Oklahoma Tax*, 514 U.S. at 199-200 (quoting *Goldberg*, 488 U.S. at 267) (emphasis in original).

activities in the State."[71] "The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State."[72]

"The fourth prong of the *Complete Auto* test thus focuses on the wide range of benefits provided to the taxpayer, not just the precise activity connected to the interstate activity at issue."[73] The Supreme Court noted that "a taxpayer's receipt of police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society satisfied the requirement that the tax be fairly related to benefits provided by the State to the taxpayer."[74] These benefits though do not have to be limited to the exact services provided by the entity being taxed.[75]

The Bank does not contest the fair relationship test because the Bank received the normal protection that a state offers, including access to courts, fire and police protection, a safe place to conduct business, as well as services furnished to the Bank's employees, such as schools, health care, and welfare benefits. Also, the Bank is authorized to lend money in accordance with Delaware laws, especially when it extends

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[71] *Id.*

[72] *Goldberg,* 488 U.S. at 266-67 (citing *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 627 (1981)).

[73] *Id.* at 267.

[74] *Id.*

[75] *Id.*

credit to others outside the state.[76] Therefore, the Bank uses Delaware law to lend money in other states, without regard to the other state's lending restrictions or usury laws. As the *Complete Auto* four-part test is met and the Bank has not met its burden to prove otherwise, Delaware's tax does not violate the Commerce Clause.

B. Due Process Clause

"The Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'"[77]

> For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise.[78]

Under this analysis, the courts look at "the fundamental fairness of governmental activity."[79] Therefore,

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[76] 12 C.F.R. § 560.110.

[77] *Quill Corp. v. North Dakota,* 504 U.S. 298, 306 (1992) (quoting *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-345 (1954)).

[78] *Mobil Oil Corp. v. Comm'r of Taxes of Vermont,* 445 U.S. 425, 436 (1980) (citing *Moorman,* 437 U.S. at 272-73.

[79] *Quill,* 504 U.S. at 299.

Due Process focuses on the "notice" or "fair warning" to the taxpayer.[80]

As previously mentioned, the Bank also argues that taxing all the Bank's income violates the Due Process Clause because no rational relationship exists between the tax and the income, as the income was earned from activities conducted outside of Delaware.

1. Minimal Connection

To satisfy the first requirement, only a "minimal connection" is necessary.[81] "The requisite 'nexus' is supplied if the corporation avails itself of the 'substantial privilege of carrying on business' within the State. . . ."[82] The court must decide whether the "connections with a State are substantial enough to legitimate the State's exercise of power over him."[83] The touchstone for the Due Process analysis is established in *International Shoe,* which requires minimum contacts.[84] Physical presence in the taxing state satisfies the minimum connection.[85] Nexus has also

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[80] *Id.*

[81] *Quill,* 504 U.S. at 303.

[82] *Mobil,* 445 U.S. 425, 436 (quoting *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435, 444-445 (1940)).

[83] *Quill,* 504 U.S. at 312.

[84] *International Shoe Co. v. State of Washington,* 326 U.S. 310, 316 (1945).

[85] *Id.* at 307-308.

been found where the taxpayer merely maintains an office in the taxing state.[86]

Despite their similar language, the nexus requirements of the Due Process and Commerce Clauses are not identical.[87] The Commerce Clause is more stringent than the Due Process Clause on the state's taxation power.[88] Here, the Bank does not dispute that it has minimum contacts with Delaware, as the Bank has physical presence here, a banking office in Wilmington, and that is where its income "hits the books." As these facts satisfy the Commerce Clause's substantial nexus requirement, that is enough to satisfy the Due Process minimal connection.

2. Rational Relationship

For the second requirement, a rational relationship must exist between the taxed income and the "values connected with the taxing State."[89] Here, the court must consider "whether the taxing power exerted by the State bears fiscal relation to protection,

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[86] *D.H. Holmes, Ltd. v. McNamara,* 486 U.S. 24, 32 (1988); *National Geographic v. Cal. Equalization Bd.,* 430 U.S. 551, 556 (1977).

[87] *Quill,* 504 U.S. at 312.

[88] *Id.* at 313. *See also J.C. Penney Nat. Bank v. Johnson,* 19 S.W.3d 831 (1999).

[89] *Moorman,* 437 U.S. at 267 (citing *Norfolk & Western R. Co. v. MO. State Tax Comm'n,* 390 U.S. 317, 325 (1968)).

opportunities and benefits given by the state."[90] The tax will be upheld "if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society."[91] "The simple but controlling question is whether the state has given anything for which it can ask return."[92] Usually, the privilege of carrying on a business in the state supports a tax.[93] Police and fire protection, emergency health services, public utilities, and "a safe climate to conduct business" have also been deemed enough to support the tax.[94] As analyzed above, the Bank receives many of Delaware's benefits and protection, thus satisfying this requirement.

The fact that the tax is "contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction."[95] In other words, it does not matter that the mortgages were originated or approved somewhere else nor that the

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[90] *J.C. Penney,* 311 U.S. at 444.

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *Bridges v. Autozone Properties, Inc.*, 900 So.2d 784, 809 (La. 2005). *See also Appeal of R.J. Reynolds Tobacco Co.*, 326 S.E.2d 911, 919 (N.C. Ct. App. 1985); *Zelinsky v. Tax Appeals Tribunal of State,* 801 N.E.2d 840, 848 (N.Y. 2003).

[95] *J.C. Penney,* 311 U.S. at 444.

funds for the mortgages came through Pittsburgh. That does not affect Delaware's ability to impose a tax.

The Supreme Court has noted that to guarantee that the rational relationship test is further satisfied, a state should use some apportionment formula, so that the risk of multiple taxation is not unreasonable.[96] As to that, Delaware's bank franchise tax allows for extraterritorial income to be apportioned through a separate accounting method, so long as the taxpayer prepares sufficient records.[97] As previously noted, an in-state bank can exclude income earned from activities conducted outside Delaware by branches or subsidiaries.[98] Also, an out-of-state bank would only include income from the in-state branch when computing its taxes.[99] Thus, a bank is able to apportion, and exclude, out-of-state income when determining its tax liability. Thereby, the Commissioner correctly held that the bank franchise tax does not violate the Due Process Clause.

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[96] *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 437-40 (1980).

[97] 5 *Del. C.* § 1101(a)-(b).

[98] 5 *Del. C.* §§ 101(4)(b), 1101(a).

[99] 5 *Del. C.* § 1101(b).

VI. Other Arguments

A. Professor Pomp's Testimony

The Bank argues that Professor Richard D. Pomp should have been allowed to testify and offer his opinion letter into evidence. During the hearing, Pomp was allowed to testify, but not about (1) the meaning of "commercial domicile" according to common usage and (2) whether the Bank's franchise tax assessment is consistent with the normative principles of state taxation. Pomp's opinion letter, which discussed these two issues, was not admitted into evidence. The Bank claims that disallowing his testimony was an abuse of discretion since Pomp was highly qualified. The Bank relies on Delaware Rules of Evidence, 702, which states that an expert witness may testify if his "specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue. . . ."

The Commissioner ruled that this evidence was irrelevant under D.R.E. 401.[100] The Commissioner found that "commercial domicile" is a legal concept, as opposed to a fact, and testimony about normative principles of taxation did "not belong on the witness stand" because these principles do not speak directly to Delaware's laws. In the alternative, the Commissioner

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[100] "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."

excluded the evidence as cumulative, since "[a]mple factual testimony existed in the record prior to Professor Pomp's proffered testimony. . . ."

The Commissioner has discretion to exclude evidence at a hearing if it is "irrelevant, immaterial, insubstantial, cumulative and privileged evidence. . . ."[101] Also as the Commissioner properly noted, expert testimony expressing an opinion concerning applicable domestic law is inadmissible.[102] Therefore, the Commissioner's discretionary decision to exclude some of Professor Pomp's testimony and opinion letter was proper.

B. Ernst & Young Analysis

The Bank also argues that if the tax is constitutional, it should be entitled to use the separate accounting methodology presented by its accounting experts, Ernst & Young, LLP. This assessment relied on 5 *Del. C.* § 1101(b), which imposes a franchise tax on banks not headquartered in the state. As discussed above, the Commissioner correctly found that the Bank was not headquartered in Delaware, and therefore not entitled to use separate accounting under 5 *Del. C.* § 1101(b). The Commissioner also concluded that the Bank did not provide enough information to

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[101] 29 *Del. C.* § 10125(b).

[102] *Itek Corp. v. Chicago Aerial Industries, Inc.*, 274 A.2d 141, 143 (Del. 1971).

support the Ernst & Young analysis, and therefore, the analysis should not be considered.

C. Commissioner's Abatement Authority

Finally, the Bank argues that the Commissioner erred in refusing to abate the Bank's tax assessment or penalties, as both the taxes and penalties were excessive, leading to an inequitable result. The Commissioner is authorized to abate both tax assessments and penalties under 5 *Del. C.* § 1114(a).[103] The Code, however, authorizes the Commissioner to abate, but does not demand that he do so.[104] Therefore, the matter is discretionary. Furthermore, as both the Commissioner and the Bank noted, the Delaware statute is almost identical to the Internal Revenue Code's abatement provision, which has been construed as a discretionary power as opposed to a duty.[105] If the Bank is correct that under the Internal Revenue Code abatement is a form of "equitable clemency,"[106] the Commissioner is still free to abate, but is not required to do so.

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[103] "The Commissioner is authorized to abate the unpaid portion of the assessment of any tax, interest, penalty, additional amount or addition to the tax, or any liability in respect thereof, which is: (1) Excessive in amount. . . ."

[104] 5 *Del. C.* § 1114(a).

[105] I.R.C. § 6404(a)(1). *Matter of Bugge,* 99 F.3d 740, 744 (5th Cir. 1996). *Wright v. C.I.R.*, T.C.M. 2004,-69 (2004).

[106] *Edelson v. C.I.R.*, 829 F.2d 828, 832 n.4 (9th Cir. 1987).

"In order to prevail on a claim that the IRS abused its discretion in failing to abate interest, a taxpayer must prove that the IRS exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law."[107] The Commissioner did not abate here because "the proposed assessment in this case was not 'excessive' in that the Bank has been assessed for the proper amount of tax and penalty due based on the correct application of the statute." Since the Commissioner has discretion on abatement and the Bank did not prove that the Commissioner exercised this authority arbitrarily, the Commissioner did not err in refusing to abate the Bank's taxes or penalties.[108]

VII.

For the foregoing reasons, the Commissioner's May 20, 2005 decision is based on substantial evidence, and it is legally sound. Therefore, it is ***AFFIRMED.***

IT IS SO ORDERED.

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[107] *McElroy v. C.I.R.*, T.C.M. 2004-254 (2004). *Dormer v. C.I.R.*, T.C.M. 2004-167 (2004).

[108] The court, however, is not adopting all the Commissioner's reasoning: that judicial notice should be taken for LBH's filings and websites touting Delaware as its principal office and headquarters; that the only requirement under HOLA is that a state tax statute treat state and nationally chartered banks alike; and that the Bank could have avoided the tax by structuring its organization differently.

/s/ Fred S. Silverman
Judge

FSS/lah
oc: Prothonotary (Civil Appeal's Division)

APPENDIX D

[LOGO]

STATE OF DELAWARE

OFFICE OF THE STATE BANK COMMISSIONER
555 E. LOOCKERMAN STREET, SUITE 210
DOVER, DELAWARE 19901

Web: www.state.de.us/bank TELEPHONE: (302) 739-4235
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May 20, 2005

VIA MAIL AND
FACSIMILE (302) 498-6211)

John S. McDaniel, Esq.
Deputy Attorney General
Carvel State Office Building
820 N. French Street
Wilmington, Delaware 19801

VIA MAIL AND
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Stanford L. Stevenson, Esq.
Morris, Nichols, Arsht & Tunnell
1201 N. Market Street, 18th Floor
Wilmington, Delaware 19801

RE: *In the Matter of Lehman Brothers, Bank, FSB*

Gentlemen:

Accompanying this letter is a copy of my Findings and Decision in the above-referenced matter.

Very truly yours,

/s/ Robert A. Glen
Robert A. Glen
State Bank Commissioner

Enclosure

[LOGO]

STATE OF DELAWARE

OFFICE OF THE STATE BANK COMMISSIONER
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Web: www.state.de.us/bank TELEPHONE: (302) 739-4235
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IN THE MATTER OF :
LEHMAN BROTHERS BANK, FSB :

FINDINGS AND DECISION OF THE STATE BANK COMMISSIONER

This matter comes before the State Bank Commissioner (the "Commissioner") to determine the liability of Lehman Brothers Bank, FSB (the "Bank") for calendar years 2000, 2001, 2002 and 2003 under the Delaware bank franchise tax, as provided in Chapter 11 of the State Banking Code, Title 5 of the Delaware Code. The Commissioner is granted the authority to administer and enforce the provisions of this tax, pursuant to Section 121(a) of Title 5. As the taxpayer, filer of the tax returns, and proponent of a tax refund, the Bank has the burden of proof.

I.

The franchise tax is imposed on banking organizations, trust companies, and federal savings banks not headquartered in this State but maintaining branches in this State, for the privilege of operating in Delaware. Those entities are exempt from the Title

30 corporation income tax and other taxes, as provided in Section 1109 of Title 5.

The franchise tax reflects the special legal and economic role of banks and trust companies. Banks are authorized to take deposits, pay checks and make loans, which generally are considered the core banking functions. *See First National Bank, in Plant City, Florida v. Dickinson,* 396 U.S. 122, 135 (1969); 12 U.S.C. §§24, 36(f), 12 CFR §5.20(e)(1) (national banks); 12 U.S.C. §1464 (federal savings banks); 5 *Del. C.* §§761(a), 770(a)(1) (state banks).

In Delaware, as in other states, only entities with a particular form of corporate charter are authorized to conduct a banking business. 5 *Del. C.* §901. All banks chartered under Delaware law are subject to supervision by the Commissioner. 5 *Del. C.* §121(a). General corporations are not permitted to engage in banking. 5 *Del. C.* §§126, 379.

National banks and federal savings banks, which are chartered by federal government agencies, are also permitted to engage in banking. National banks are chartered and regulated by the Office of the Comptroller of the Currency ("OCC") pursuant to the National Bank Act. 12 U.S.C. §§21 *et seq.* Federal savings banks are chartered and regulated by the Office of Thrift Supervision ("OTS") pursuant to the Home Owners' Loan Act ("HOLA"), 12 U.S.C. §§1461 *et seq.*

Banks in Delaware enjoy special rights and privileges under both State and federal banking laws.

State bank powers, including the right to receive deposits, are specified in Section 761 of Title 5. The powers of national banks and federal savings banks are provided by federal law. 12 U.S.C. §24 (national banks); 12 U.S.C. §1464 (federal savings banks). Extensions of credit by banks are not subject to usury laws that might otherwise apply. 5 *Del. C.* §§953, 973; *compare* 6 *Del. C.* §2301.

State and federal banks are also subject to particular operating restrictions and consumer protection obligations. The home office or place of business must be identified in the organization's charter and may only be changed with the approval of the applicable State or federal regulator. 5 *Del. C.* §§723(a)(3), 749 (state banks); 12 U.S.C. §§22, 30, 12 CFR §§5.20, 5.40 (national banks); 12 U.S.C. §1464(a), 12 CFR §§552.2-1(c), 552.3, 552.4(b)(2), 545.95 (federal savings banks).[1] Similarly, banks may only open branch offices, the places in addition to the home office where deposits are received, checks paid or money lent, upon application to and approval by the applicable State or federal regulator. 5 *Del. C.* §770 (State banks); 12 U.S.C. § 36, 12 CFR §5.30 (national

[1] On November 24, 2004, OTS issued an interim final rule amending its regulations to modify the application and notice procedures for establishing a new branch office, changing the permanent location of an existing home or branch office, and changing the designation of an office as home or branch. 69 FR 68239. These amendments became effective January 1, 2005. All citations to OTS regulations, however, will refer to the previous rules.

banks); 12 U.S.C. §1464(m), 12 CFR §§545.93, 545.94 (federal savings banks). Banks are required to make economic contributions to the communities in which they are located, pursuant to the Community Reinvestment Act ("CRA"). 12 U.S.C. §§2901 *et seq*.

The locational restrictions on a bank's home and branch offices have important legal and regulatory consequences, and provide a bank located in Delaware with distinct advantages. A bank is authorized to lend money in accordance with the laws of the State where it is located, and may "export" those laws by extending credit on those terms to customers in other states. 12 U.S.C. §1831d (state banks); 12 U.S.C. §85, 12 CFR §7.4001 (national banks); 12 U.S.C. §1463(g), 12 CFR §560.110 (federal savings banks); *Capalli v. Nordstrom, FSB,* 155 F.Supp.2d 339, 341 (E.D.Pa. 2001), *aff'd by unpublished opinion* 2002 WL229495 (3rd Cir. 2002) (interest charges allowed by a federal savings bank's home state may be imposed on out-of-state customers). This enables a bank located in Delaware to lend money to customers in other states pursuant to Delaware law, without regard to other states' lending restrictions or usury laws. A bank may borrow funds from a Federal Home Loan Bank, specifically the Federal Home Loan Bank of Pittsburgh for a bank located in Delaware. 12 U.S.C. §1424(a), 12 CFR Pt. 905, Subpart A, App. A. A federal savings bank located in Delaware may act as a fiduciary and offer Delaware advantaged trust services. 12 U.S.C. §1464(n), 12 CFR §550.135. The location of the bank's main and branch offices also

determines its CRA assessment area. 12 CFR §563e.41(c)(2). Delaware's small size and population may make the CRA obligations of a bank located in Delaware more manageable than if the bank were located in a larger community, such as New York.

The bank franchise tax imposed for the privilege of operating in Delaware is applied equally to State-chartered banks and national banks and federal savings banks with their principal offices in the State. 5 *Del. C.* §§101(4), 1101(a). Federal law permits a state to tax national banks and federal savings banks in the same manner as banks chartered in the state. 12 U.S.C. §548 (national banks), §1464(h) (federal savings banks).

The franchise tax is imposed on the bank's "taxable income", which is calculated based on the bank's net operating income before taxes, with certain adjustments. Those adjustments include deductions for out-of-state branches and subsidiaries for "[t]hat portion of net operating income before taxes, verifiable by documentary evidence," that is "[d]erived from business activities carried on outside the State and subject to income taxation under the laws of another state . . . " 5 *Del. C.* §1101(a)(1)b. Delaware taxes only 56% of the bank's adjusted net operating income before taxes. 5 *Del. C.* §1101(a)(2).

Out-of-state banks with branches in Delaware also are subject to the bank franchise tax, but to a more limited extent. The "taxable income" of a federal savings bank not headquartered in this State but

maintaining branches in this State is "equal to the net operating income of the branch or branches located in Delaware before taxes", with certain adjustments. 5 *Del. C.* §1101(b).

The procedure for filing and payment of the franchise tax is set forth in Chapter 11 of Title 5, and in certain regulations adopted by the Commissioner. A bank is required to file an annual statement of net income, as well as a statement of taxable income. 5 *Del. C.* §§904, 905, 1102. Most banks in Delaware report income and pay tax on a calendar year basis, and the statement is due on January 30 of the following year. State Bank Commissioner Regulations 1103, 1106, 1110, 5 Del. Admin. Code 1103, 1106, 1110. The regressive tax rates, as well as certain tax credits, are set forth in Section 1105 of Title 5. The annual franchise tax is due the following March 1. 5 *Del. C.* §1104(a). A bank with estimated franchise tax liability for the current year exceeding $10,000 also is required to file an estimated tax return on March 1 of the current income year. *Id.* Estimated tax payments must be made throughout the year, and additional tax is assessed for the underpayment of estimated tax. 5 *Del. C.* §1104(b),(c). A penalty also is assessed for the late payment of tax. 5 *Del. C.* §1104(e).

II.

The process for arriving at a final determination of a bank's franchise tax liability by the Commissioner is governed by certain provisions of Title 5, as

well as the Administrative Procedures Act (the "APA"), Chapter 101 of Title 29 of the Delaware Code. The Commissioner is subject to all of the provisions of the APA. 29 *Del. C.* §10161(a)(2). Accordingly, the process must comply with the provisions regarding Case Decisions in Subchapter III of the APA.

The Case Decision process under the APA is initiated by a Notice of Proceedings. 29 *Del. C.* §10122. Among other things, the notice provides the parties with the opportunity to elect informal fact-finding, and in the absence of such election sets forth the date, time and place of a formal public evidentiary hearing. 29 *Del. C.* §§10122, 10124.

The Commissioner is not permitted to disclose confidential information about a bank's income or its franchise tax return, as provided in Section 1113 of Title 5. To comply with this restriction, that portion of any hearing to determine tax liability dealing with such information must be closed to the public.

The State Banking Code provides that "[t]he Attorney General shall act as the legal representative of the State in all actions or proceedings had under this chapter, and shall render legal assistance to the State Bank Commissioner in executing the provisions hereof." 5 *Del. C.* §1107. In order to provide due process, the Attorney General or her representative who advocates the State's interests in the proceeding must act separately from the Commissioner, in accordance with the principles set forth in *Blinder,*

Robinson v. Bruton, 552 A.2d 466, 473 (Del.1989), and *Withrow v. Larkin,* 421 U.S. 35 (1975).

In general, the Commissioner must assess the franchise tax "within 3 years after the last day prescribed for filing the return or, if later, the date the return was filed." 5 *Del. C.* §1111(a). This period may be extended by agreement between the Commissioner and the taxpayer. 5 *Del. C.* §1111(c). The taxpayer generally has a comparable period of time to claim a refund. 5 *Del. C.* §1112.

The Commissioner is authorized to abate the franchise tax under certain circumstances. 5 *Del. C.* §1114. The Commissioner and the taxpayer also may enter into a closing agreement with respect to the tax. 5 *Del. C.* §1115.

III.

The hearing to determine the Bank's franchise tax liability for calendar years 2000, 2001, 2002 and 2003 was convened on September 30, 2004. The Bank appeared represented by counsel. A Deputy Attorney General appeared to advocate the State's interest in collecting the tax. Portions of the hearing dealing with confidential information were closed to the public as required by Section 1113 of Title 5. I find that the evidence introduced at the hearing established the following facts.

For a number of years prior to 1999, the Lehman organization had been seeking a federal savings bank

to conduct its nationwide mortgage lending operation. Tr. 84-88.[2] The Lehman organization believed that federally insured deposits and loans from a Federal Home Loan Bank would protect its mortgage business by providing a more stable source of funding. Tr. 86-90, 98. For that reason, it had been in contact with the OTS for a number of years as part of that search. Tr. 87-88.

In early 1999, the Lehman organization learned that Delaware Savings Bank, FSB, a federal savings bank chartered by the OTS, was a good candidate for acquisition because of that institution's poor financial condition. Stip. ¶ 2; Tr. 88-89. Regulatory approval was accelerated and on or about July 1, 1999, Lehman Brothers Holdings, Inc. acquired Delaware Savings Bank, changing its name to "Lehman Brothers Bank, FSB". Tr. 89; Stip. ¶ 5. The original purchase price was $2,000,000 in cash with an assumption of approximately $6,000,000 in liabilities. Assumed liabilities later grew by somewhere between $2,000,000 to $3,000,000. Tr. 83-84.

The Bank's Federal Stock Charter was issued by the OTS, dated June 30, 1999. Stip. ¶ 2; Ex. 4-1. As a federal savings bank, the Bank is supervised by the

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[2] This abbreviation refers to the September 30, 2004 hearing. "Tr. ___" will refer to pages in the transcript of the hearing. "Stip. ¶ ___" will refer to paragraphs in the parties' joint stipulation of facts, admitted as Hearing Exhibit 4. "Ex. ___" will refer to exhibits admitted at the hearing.

OTS and governed by that agency's regulations.[3] Tr. 111-112. Those regulations require all federal savings banks to specify the location of a home office in their charters. *See* 12 CFR § 552.2-1(c), § 552.3 charter section 2. Pursuant to that requirement, the Bank in its charter designated Wilmington, Delaware as the location of the home office. Stip. ¶¶ 2, 7; Ex. 4-1. That designation has never changed. *Id.* Under 12 CFR § 545.91, all operations of a federal savings bank "shall be subject to direction from the home office." OTS approval of a charter amendment is required to change a home office location. 12 CFR §§ 545.95, 552.4(b)(2).

Because its home office is in Delaware, the Bank is a member of the Federal Home Loan Bank of Pittsburgh, which serves Delaware, Pennsylvania, and West Virginia, but not New York. Tr. 61, 96, 115; 12 USC §§ 1423, 1424(b); 12 CFR § 925.18(a) & Pt. 905, Subpart A, App. A. The separate Federal Home Loan Bank of New York serves member banks with home offices in that state, Tr. 125, 132; 12 USC § 1424(h); 12 CFR § 925.18(a) & Pt. 905, Subpart A, App. A.

Likewise, because of the Wilmington home office location, the OTS designated the metropolitan statistical area that includes Wilmington, Delaware as the

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[3] The Federal Deposit Insurance Corporation is also a secondary regulator because the Bank has FDIC insured deposits. Stip. ¶ 3; Tr. 112.

Bank's CRA assessment area for its required investment and service tests. Tr. 134-135; Ex. 4-24.

The OTS must also approve the establishment of both branches and subsidiaries. *See* 12 CFR §§ 545.92, 545.93, 559.3 and 559.11. A branch is defined as any office other than the home office, an agency office, administrative office, data processing office, or an electronic means or facility. 12 CFR § 545.92(a). An operating subsidiary may be organized in any location and engage in any activity that the bank itself may conduct directly. 12 CFR § 559.3(d), (e).

Until January 2004, the Bank had no out-of-state branches,[4] and its only Delaware branch closed in December, 2000. Ex. 4-15, -16, -17, -18; Tr. 138. On August 6, 2003, the Bank applied to the OTS for approval to open a branch in Jersey City, New Jersey. This was granted on September 5, 2003, to be effective January 26, 2004. Ex. 4-25; Tr. 131-132.

For the years in question, the Bank had only one subsidiary, an affiliate conducting a reverse mortgage operation from offices in California. Ex. 4-2, -15, -16, -17, -18, -25. On October 15, 2003, the Bank filed an application for another subsidiary, which was approved with an effective date of April 22, 2004. Ex. 4-25.

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[4] The General Information Questionnaire that the Bank submitted in January, 2001 lists a Maryland loan production office, but this type of facility is not considered a branch. Ex. 4-15.

The Bank maintains an office in New York City, which its representatives characterize as its "executive offices." Stip. ¶ 9; Tr. 129, 170. This office is neither the home office nor a branch of the Bank. The senior management of the Bank works at this office in New York. Tr. 145-147.

Pursuant to OTS requirements, the Bank files Thrift Financial Reports each quarter. These reports contain comprehensive financial information on its activities, including a balance sheet and income statement. 12 USC § 1463; 12 CFR §§ 562.1, 562.2; Tr. 306-307; See also Ex. 4-2. The OTS uses these reports for general oversight, as well as safety and soundness purposes. Because they provide a high degree of confidence in their accuracy, these reports are also used to compute the Delaware bank franchise tax. Tr. 307.

The Bank engages in local retail banking in New Castle County, Delaware, conducts nationwide mortgage, corporate, commercial and warehouse lending, and operates a nationwide trust service. Tr. 31, 50, 137-138; Ex. 4-19. In the response to the General Information Questionnaire sent to the Commissioner's office for 2000, the Bank described the type of business it was then conducting as "retail banking – savings and mortgage loan products". Ex. 4-15. For 2001 through 2003, the Bank described its business in that same report as "retail and mortgage banking activities". Ex. 4-16, -17, -18. The trust operation began in 2002 and is conducted in Delaware, even though the senior trust officer is based in New York.

Tr. 73-74; Ex. 4-19, 21. Approximately 97% of the Bank's income is derived from loans. Ex. 4-21.

For the years in question, the Bank had between 11 and 13 employees at its Delaware home office and 20 to 25 full-time employees in New York. Tr. 28-29. It also shared another 90 dual employees working in Colorado and New York with two other affiliates of the Lehman organization. Tr. 28, 30-31. Of the Delaware home office personnel, 50% engage in retail banking activities, while the remaining 50% perform accounting and other support services for the Bank as a whole. Tr. 143-144. During that same period, the Bank had between 5 and 6 corporate officers. Stip. ¶ 8; Ex. 4-15, -16, -17, -18. Of these, only one had an office in Delaware. Tr. 146-147. All board meetings have been held in New York. Tr. 51.

The establishment, administration, and disbursement activities for the Bank's trust operations are conducted in Delaware, as is local retail banking. Tr. 52, 138-139; Ex. 4-21. Activities related to the marketing and administration of its certificate of deposit and its nationwide loan programs are performed by personnel in New York and Colorado. Tr. 28-38. None of the Bank's Delaware employees conduct mortgage purchase and sale activities. Tr. 144.

All funds generated by certificates of deposit are at some point deposited into the Bank's accounts in Wilmington, Delaware. Tr. 99, 102, 104. This is the only location where the Bank can accept deposits. Tr.

102. All certificates of deposit are issued in the name of "Lehman Brothers Bank". Tr. 98-99.

Soon after Lehman acquired the Bank in 1999, the amount of federally insured deposits exceeded original estimates by a significant amount, and these became one its largest sources of funding. Tr. 36, 61, 91-92, 98, 105. Brokered certificates of deposit (CDs) represented about 25 to 35 percent of the Bank's funding on a daily basis. Tr. 104.

Consistent with its original funding plans, the Bank began borrowing from the Federal Home Loan Bank of Pittsburgh, which also became a major source of funds. Tr. 36-37, 218-219. As security for that borrowing, the Bank would pledge its residential and commercial mortgages. Tr. 36-37, 39, 61; 12 USC § 1430. Federal Home Loan Bank borrowings represented about 50 to 60 percent of the Bank's funding. Aside from this and the brokered CDs, all other sources of funds, including equity, made up only 10 to 15 percent of the Bank's funding. Tr. 105

The Thrift Financial Reports (TFRs) filed with the OTS report the Bank's net operating income before taxes, on a noncumulative quarterly basis, on Schedule SO, Line SO60, Ex. 4-2, as follows:

Quarter Ending	Income Before Taxes
March 31, 2000	$24,150,000
June 30, 2000	$38,208,000
September 30, 2000	$31,564,000
December 31, 2000	$19,173,000
March 31, 2001	$42,967,000

June 30, 2001	$45,150,000
September 30, 2001	$52,361,000
December 31, 2001	$85,695,000
March 31,2002	$85,658,000
June 30, 2002	$80,566,000
September 30, 2002	$93,765,000
December 31, 2002	$146,212,000
March 31, 2003	$160,485,000
June 30, 2003	$168,406,000
September 30, 2003	$176,540,000
December 31, 2003	$161,076,000

The Bank paid the following franchise tax for each of the calendar years at issue; $2,355,000 for 2000; $3,209,860 for 2001; $4,570,872 for 2002; and $6,800,000 for 2003. Stip. ¶ 18.

In each of the years in question, the Bank originally filed its tax return under Section 1101(a) as a banking organization with its principal place of business in Delaware. Ex. 4-3, -4, -5, -6. For 2000 to 2002, the Bank claimed a deduction of 50% of its income on line 4(b) of the tax return. Line 4(b) is based on the provision in Section 1101(a)(1)b of Title 5, which excludes from a bank's taxable income "[t]hat portion of its net operating income before taxes, verifiable by documentary evidence, from any subsidiary or . . . branch established with the United States but outside of this State pursuant to federal law . . . which is . . . [d]erived from business activities carried on outside the State and subject to income taxation under the laws of another state . . . "

When a bank claims this line 4(b) deduction, it must submit supporting documentation with its return. 5 *Del. C.* §1101(a)(1)b; 5 DE Admin. Code § 1105 Item 4. In early 2002, as part of a review of the Bank's 2001 return, the Deputy Bank Commissioner for Tax Administration and Reporting (the "Deputy Commissioner") discovered that the required documentation was missing, and a review of the 2000 return revealed a similar short-coming. Tr. 326-327. The Deputy Commissioner promptly notified the Bank of its deficiency and specifically asked for the required documentation, Tr. 326. Despite repeated requests for more than a year, the Bank never adequately responded, but instead, repeated the same omission in its 2002 return, as well. Tr. 326-328, 337-338; Ex. 4-5. In a letter dated October 6, 2003, the Commissioner advised the Bank that the review of the 2000, 2001 and 2002 tax returns revealed a deficiency in the tax calculation, and that the bank's tax liability had been recalculated based on the disallowance of the line 4(b) deduction, for which no supporting documentation had been provided by the Bank. Ex. 4-11.

After the Bank disputed this computation, the Commissioner issued a notice initiating a proceeding to reach a final determination of the Bank's franchise tax assessment for 2000, 2001 and 2002, pursuant to the APA. Ex. 4-13. The Bank and the Commissioner agreed by separate stipulations to extend until May 28, 2005 the time for the final assessment of the tax at issue for 2000 and 2001.

On January 28, 2004, the Bank submitted its 2003 return in which it did not claim a similar deduction on line 4(b), but rather reported on line 1, without any explanation, a dramatically lower amount of income than that reported on the TFRs submitted to the OTS. Compare Ex. 4-6 with Ex. 4-2. Under the Delaware bank franchise tax, the income a federal savings bank reports on its TFR must coincide with the income on its return. Tr. 306-310, 313. Once again, the Bank submitted its return as a banking organization with its principal place of business in Delaware. Ex. 4-6.

On August 2, 2004, the Commissioner sent the Bank another notice of proceedings, this one to determine the accuracy of the Bank's 2003 franchise tax assessment, as well as those for 2000, 2001 and 2002. Ex. 4-14. In a letter dated September 23, 2004, the Commissioner advised the Bank of the proposed recalculation of the Bank's tax assessment for all four years, including a computation for 2003 based on its TFR. Ex. 4-12.

After receiving the August 2, 2004 notice, the Bank submitted amended returns for all four years in question, prepared with the assistance of representatives of Ernst & Young. Stip. ¶ 29; Ex. 4-7, -8, -9, -10.[5]

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[5] These returns are attached to an August 27, 2004 report from the accounting firm of Ernst & Young, LLP, Ex. 4-21; Stip. ¶ 29. Although signed, they are not otherwise dated. Ex. 4-7, -8, -9, -10.

These amended returns were prepared on the basis that the Bank was not headquartered in Delaware and therefore should be taxed as a branch under Section 1101(b) of Title 5. This subsection imposes the franchise tax on the taxable income of "federal savings banks not headquartered in this State, but maintaining branches in this State, verifiable by documentary evidence". The tax under this subsection is imposed only on the income of the Delaware branch, with adjustments not at issue here.

In submitting amended returns shortly before the September 30 hearing, the Bank for the first time indicated that it was using the separate accounting method in an effort to segregate income generated by its nationwide trust and local Delaware retail operations. Ex. 4-21.[6] As explained below, I have determined that the Bank is not entitled to use separate accounting. In any event, the Bank did not employ a proper methodology.

Separate accounting is an accepted procedure commonly used to determine the specific location where income is generated and expenses incurred. Tr. 165, 376-377. When performed correctly, this method allocates income and expense items to a geographic source, and can segregate the revenue of particular

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[6] The PriceWaterhouseCoopers Report indicates that the original 2003 return was based on the Bank's own separate accounting analysis (Ex. 8), but the Bank did not submit any such analysis with that return. *See* Ex. 4-6.

business operations, including bank branches, that are located in a particular jurisdiction. Tr. 266, 292, 381, 389. This methodology is within generally accepted accounting principles, and it is recognized in many states. Tr. 251-252, 257-259.

The Bank's attempt to use this process to isolate Delaware income on its amended returns was defective and produced a flawed result. Tr. 389-390, 399-400. The Bank failed to prepare a separate Delaware balance sheet. Tr. 389-390, 392-393. In addition, the income the Bank attributed to Delaware failed to take account of a proper funding facilitation cost and interest rate risk under transfer pricing standards. Tr. 384, 389-390, 392-393, 398-400. The accounting did not consider the interest that the home office should charge to the mortgage operation because the home office was the source of deposit funds, nor did it reflect the Federal Home Loan Bank borrowings that the home office obtained to fund that same operation. Tr. 384-385, 389-390, 392-394. Interest expense did not reflect such deposits or borrowings. Tr. 385-386. Even assuming that this methodology might be appropriate for the calculation of the Bank's franchise tax, insufficient information is available for an accurate separate Delaware accounting. Tr. 398-400.

Further consideration of a separate accounting for the Delaware operation is not necessary, however, as a result of the following conclusions of law.

IV.

A.

Based on the facts established at the hearing, I conclude that the Bank is a federal savings bank with its principal office in Delaware and, as such, is included within the definition of a "banking organization" in Section 101(4) of Title 5. The Bank, therefore, is subject to the franchise tax pursuant to Section 1101(a) of Title 5. Consequently, I cannot accept the Bank's argument that it is a "federal savings bank not headquartered in this State but maintaining branches in this State" within the meaning of Section 1101(b) of Title 5.

With regard to federally chartered institutions, whether national banks chartered by the OCC or federal savings banks chartered by the OTS, we traditionally have deferred to the bank's federal chartering authority to determine the location of the bank's principal office for franchise tax purposes. This practice of deferring to the federal chartering authority for such determinations is reflected in a statutory provision in the Delaware Banking Code, Section 801(5) ("'Located in this State' means, with respect to state-chartered banks, banks created under the law of this State and, with respect to national banking associations, banks whose organization certificate identifies an address in this State as the place at which its discount and deposit operations are to be carried out."). Section 801(5) is specifically cross-referenced in the franchise tax provisions at Section

1101(a)(1)b.2 of Title 5. This applies to a federal savings bank as well, which for certain purposes of the Delaware Banking Code falls within the definition of a national bank. 5 *Del. C.* §101(4)b; *see also,* 5 *Del. C.* §101(17).

In this case, the charter designation of Wilmington, Delaware as the location of the Bank's home office, in accordance with the OTS regulations, is conclusive. The OTS requires the Bank to designate its home office in its charter, 12 CFR §552.2-1(c), §552.3 charter section 2. This designation may only be changed after application to and approval by the OTS. 12 CFR §§545.95, 552.4(b)(2). The Bank has never applied to the OTS to change the designation of Wilmington, Delaware as the location of its home office. The OTS regulations specifically equate the terms "home office" and "principal office". 12 CFR §561.39. Furthermore, under OTS regulations, the home office in Delaware cannot be considered a "branch." 12 CFR §545.92(a).

As a federal savings bank with its principal office in this State, the Bank is included within the definition of a "banking organization" in Section 101(4) of Title 5 and subject to the franchise tax under Section 1101(a), the same as any other bank organized under the laws of the State of Delaware. This is authorized by the state tax parity provision for federal savings banks in the HOLA, at 12 U.S.C. §1464(h) ("No State, county, municipal, or local taxing authority may impose any tax on Federal savings associations or their franchise, capital, reserves, surplus, loans or

income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.").

The traditional definitions of "principal office" in Section 101(4)b. and of "headquartered" in Section 1101(b) of Title 5 should not be reinterpreted to mean an office other than the "home office" of the Bank identified in its organization certificate, as approved by the OTS. Any other . `clusion would distort the plain meaning of those terms, which for these purposes are synonymous.

Moreover, the charter designation of Wilmington, Delaware, as the location of the Bank's home office, has important consequences, which would make it inappropriate to differentiate "principal office", "headquartered" and "home office" only for Delaware franchise tax purposes. The OTS regulations specify that all operations of a federal savings bank "shall be subject to direction from the home office." 12 CFR §545.91. A federal savings bank "may become a member only of, or secure advance from, the Federal Home Loan Bank in the district in which is located the institution's principal place of business." 12 U.S.C. §1424(b). The Bank borrowed extensively from the Federal Home Loan Bank of Pittsburgh, which serves the district including Delaware, and never designated anywhere other than Delaware as the Bank's principal place of business, although it might have done so if it had met certain criteria. 12 CFR §925.18(c).

The Bank also obtained other legal, regulatory and business advantages from its Delaware location, which enabled the Bank to export the Delaware interest rate and to advertise the ability to offer Delaware advantaged trust services to customers nationwide. The Bank's CRA assessment area was designated as Wilmington, Delaware. Conversely, the Bank's Delaware location assisted it in avoiding the potential application of other states' usury and consumer protection laws, as well as more expansive CRA obligations to which it might have been subject in a different city or state.

Having designated Delaware as the location of its home office and taken advantage of the benefits of that designation, the Bank should not now be heard to complain about the accompanying state tax consequences. The United States Supreme Court has observed that while a taxpayer is free to organize its affairs as it chooses, once it has done so, it must accept the consequences of that choice. A taxpayer may not enjoy the benefit of another route it could have chosen to follow, but did not. *C.I.R. v. National Alfalfa Dehydrating and Milling Co.,* 417 U.S. 134, 148-149 (1974). *See also, Spinoza, Inc. v. United States,* 379 F.Supp. 439, 443 (S.D.Tex. 1974) (taxpayers are bound by what they did and cannot ignore the form in which they chose to do business); *Balthorpe v. C.I.R.*, 356 F.2d 28, 34 (5th Cir. 1966) ("when a taxpayer has failed to minimize his taxes, he cannot expect the court to do it for him nunc pro tunc").

B.

I further conclude that the Bank had no branches outside of Delaware and derived no income from any subsidiary outside of Delaware during the years in question. Therefore, the Bank is not entitled to any deduction on line 4(b) of its franchise tax returns for those years, and it is not necessary to consider the adequacy of any separate accounting of the Bank's income to operations within or without the State of Delaware.

Section 1101(a)(1)b of Title 5 provides, in pertinent part, for the exclusion from taxable income of "[t]hat portion of net operating income before taxes, verifiable by documentary evidence, from any subsidiary or . . . branch established within the United States but outside of this State pursuant to federal law . . . " As with the determination of the location of the Bank's principal office for purposes of the Delaware franchise tax, the OTS's determination of the location of the Bank's branches is conclusive. In this case, the evidence at the hearing established that the OTS had not approved, and the Bank had not opened, any branch outside of Delaware during the years in question. The Bank did not submit any evidence at the hearing that any income was derived from a subsidiary located outside Delaware.

Notwithstanding the Bank's argument, I conclude that the traditional definition of "branch" as used in Section 1101(a) of Title 5 should not be expanded to include other types of offices or facilities

not approved as branches by the OTS. What the Bank refers to as its New York "executive office", a term that appears to have no regulatory or legal significance, is not the equivalent of a branch that is approved by its primary banking regulator to perform the core banking functions of accepting deposits, paying checks or lending money.

C.

I reject the Bank's argument that the United States Constitution requires a special interpretation of "branch", "principal office" and/or "headquartered", solely for purposes of administering the Delaware bank franchise tax, in order to satisfy the Commerce or Due Process Clauses, U.S. Court., art. I, § 8, cl. 3 and amend. XIV, cl. 1.

The statutory provisions for the bank franchise tax bear a strong presumption of constitutionality. All reasonable doubts will be resolved in favor of a statute's validity, and if a constitutional construction is possible, it will be followed. In attacking the constitutionality of this statute, the Bank also bears the burden of overcoming this presumption with clear and convincing evidence. *Atlantis I Condominium Association v. Bryson,* 403 A.2d 711, 714 (Del. 1979); *Justice v. Gatchell,* 325 A.2d 97, 102 (Del. 1974).

The Commerce Clause gives the Congress the power to legislate with respect to state taxation of interstate commerce. In the HOLA, the Congress established that the sole requirement for taxation of a

federal savings bank is that the tax be no greater than the tax imposed on similar institutions. 12 U.S.C. § 1464(h). Therefore, all that the Commerce Clause requires is parity in the treatment of federal and state banks. The franchise tax satisfies that requirement, because all "banking organizations", whether state-chartered or national banks or federal savings banks with their principal office in Delaware, are taxed the same.

The Bank argues, however, that its commercial domicile is not in Delaware,[7] and that the franchise tax must be administered in a way that satisfies a four-part test established by the United States Supreme Court for determining the constitutionality, under the Commerce Clause, of state taxation for nondomiciliary corporations. The elements of this test are whether (i) the activity taxed has a substantial

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[7] At the September 30, 2004 hearing, the Bank's counsel sought to introduce as expert testimony the opinion of Professor Pomp about the Bank's commercial domicile, legal principles of taxation applied in other states, and a model statute, the Uniform Division of Income for Tax Purposes Act (UDITPA), that has not been enacted in Delaware. I excluded Professor Pomp's testimony to the extent that it was "about law or policy or what should be the law or what the law is in other states", Tr. 292, based on my discretion to exclude "evidence that I consider to be irrelevant or that intrudes into my prerogative as the trier of fact and the ultimate decision-maker in the case." Tr. 296. *See In re: The Walt Disney Company*, 2004 WL 550750 (Del. Ch. 2004) (Delaware law requires exclusion of expert testimony expressing a legal opinion). The substance of Professor Pomp's arguments about the Bank's commercial domicile were included in the post-hearing briefs submitted by the Bank's counsel.

nexus to the taxing state, (ii) the tax is fairly apportioned, (iii) the tax does not discriminate against interstate commerce, and (iv) the tax is fairly related to the services provided by the taxing state. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279, 287 (1977). *See also Oklahoma Tax Commission v. Jefferson Lines, Inc.,* 514 U.S. 175, 183 (1995); *Quill Corporation v. North Dakota,* 504 U.S. 298, 311 (1992). Nexus requires only a minimal connection with the taxing state, and this standard is fulfilled if a taxpayer avails itself of the privilege of carrying on business within a state. *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 165-166 (1983). *See also, Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 437 (1980) and *Exxon Corporation v. Wisconsin Department of Revenue,* 447 U.S. 207, 220 (1980) (both decisions upholding a state tax when the taxpayer's only presence was a marketing operation). In order to be fairly apportioned, the state tax on nondomiciliaries must be both externally and internally consistent. *Container Corp.,* 463 U.S. at 169; *Jefferson Lines,* 514 U.S. at 185. Internal consistency means that, if every jurisdiction used the same allocation system, no more than all of the taxpayer's income would be taxed. *Container Corp.,* 463 U.S. at 169. External consistency means that the system does not reach "beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Jefferson Lines*, 514 U.S. at 185.

Even assuming that the *Complete Auto Transit* test were applicable here, I conclude that the franchise tax satisfies that standard. According to the Bank, the main issue for this case under the *Complete Auto Transit* test seems to involve the second prong, the requirement that the tax be fairly apportioned to activities carried on by the taxpayer in the State.

States have wide latitude in devising constitutionally sufficient methods of fairly apportioning the income of nondomiciliary taxpayers. The United States Supreme Court has explicitly refused to impose strict constitutional constraints on a state's selection of a particular income allocation formula and has specifically held that it will disturb such a system only when a taxpayer has proved by "clear and cogent evidence" that the method is constitutionally improper. *Moorman Manufacturing Company v. Bair,* 437 U.S. 267, 274 (1978). The Constitution does not impose any single formula on the states, nor does it require that a state conform to the prevailing approach adopted by other states. In fact, the elimination of all overlapping taxation is not even required. *Container Corp.,* 463 U.S. at 164, 171.

The Delaware franchise tax satisfies both elements, for internal and external consistency, of the fair apportionment prong of the *Complete Auto Transit* test. The franchise tax is internally consistent because it excludes from taxable income that portion attributable to out-of-state branches and subsidiaries. Conversely, the franchise tax only applies to Delaware branches of out-of-state banks to the extent of

their income-producing activities here. If all other states used the same allocation system, no more than all of any bank's income would be taxed. This meets the definition of internal consistency set forth in *Container Corp.*, 463 U.S. at 169. The franchise tax is externally consistent for the same reason. In this case, all of the Bank's funding is attributable to Delaware. With the Bank having its home office in Delaware and no approved branch outside the State during the years at issue, Delaware was the only place where the Bank was authorized to receive insured deposits. The Bank's Delaware location also gave it access to borrowings from the Federal Home Loan Bank of Pittsburgh. These sources of funds, in addition to the Bank's equity, supported virtually all of the Bank's lending activities, from which it derived virtually all of its income. Thus, the franchise tax does not reach "beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Jefferson Lines,* 514 U.S. at 185.

Considering the remaining three prongs of the *Complete Auto Transit* test, the first of those, the substantial nexus requirement, is satisfied here by the operation of the Bank's home office in the State. The third prong, prohibiting discrimination, is satisfied because the Bank is taxed in the same manner as other banks chartered by the State, as permitted in the HOLA at 12 U.S.C. § 1464(h). In this regard, the Bank's reliance on *Kraft Foods, Inc. v. Iowa Department of Revenue,* 505 U.S. 71 (1992), *Conoco, Inc. v. Taxation and Revenue Department,* 931 P.2d 730

(N.M. 1996), and *General Motors Corp. v. Director of Revenue,* 981 S.W.2d 561 (Mo. 1998), is misplaced because those cases all involved revenue statutes that in some way discriminated against out-of-state businesses by favoring local enterprises. The fourth prong, requiring a fair relation of the tax to the services provided by the State, is satisfied by the benefits obtained by the Bank due to its location in Delaware, including its ability to export the Delaware interest rate and offer Delaware advantaged trust services, and access to federally insured deposits and funds borrowed from the Federal Home Loan Bank of Pittsburgh.

The Due Process Clause standard was set forth by the Court in *Moorman.* "First, no tax may be imposed, unless there is some minimal connection between those activities and the taxing State. . . . Second, the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." 437 U.S. at 273 (citations omitted). The Due Process Clause requires only minimal contacts with the taxing state, which are more than satisfied here.

Moreover, the Bank's designation of Wilmington, Delaware as the location of its home office, combined with the absence of any branches outside Delaware during the years at issue, establishes that the Bank is a Delaware resident for franchise tax purposes. A state has the constitutional power to tax all of the income of its residents, no matter where that income is earned. *Oklahoma Tax Commission v. Chickasaw*

Nation, 515 U.S. 450, 462-63 (1995) (applying "a well established principle of interstate and international taxation – namely, that a jurisdiction, such as Oklahoma, may tax *all* the income of its residents, even income earned outside the taxing jurisdiction"); *New York ex rel. Cohn v. Graves,* 300 U.S. 308, 313 (1937) ("Domicil itself affords a basis for such taxation"); *Lawrence v. State Tax Commission,* 286 U.S. 276 (1932) (upholding Mississippi's power to tax the Tennessee derived income of a Mississippi resident); *Chase Manhattan Bank v. Gavin,* 733 A.2d 782 (Conn. 1999) (upholding Connecticut's right to tax the non-Connecticut income of its resident trusts), *cert. denied,* 528 U.S. 965 (1999); *District of Columbia v. Chase Manhattan Bank,* 689 A.2d 539, 544 (D.C. App. 1997) ("a state may tax the entire income of one of its residents (including a corporation), even if some or all of that income is earned in another state"); *Commercial Credit Consumer Services Inc. v. Norberg,* 518 A.2d 1336 (R.I. 1986) (Rhode Island tax on banking organizations did not discriminate against interstate commerce because it was levied on all banking institutions domiciled there regardless of whether they were engaged in interstate commerce or purely in intrastate activities). This taxing authority over residents contrasts with the more limited authority over nonresidents, for whom "jurisdictions generally may tax only income earned within the jurisdiction." *Chickasaw Nation,* 515 U.S. at 463 n. 11. As stated above, Congress has expressly authorized under the Commerce Clause the taxation of federal savings banks to the same extent as that of state-chartered

banks. 12 U.S.C. §1464(h). Accordingly, Delaware has the constitutional power to tax all of the Bank's income and no special interpretation of the term "branch" is necessary to comply with the Commerce or Due Process Clauses.

V.

Based on the foregoing findings of fact and conclusions of law, the following is my assessment of the franchise tax owed by the Bank for the years 2000 through 2003, plus penalties. As set forth below, the Bank's net operating income before taxes for each year is the sum of its income before taxes as reported in each quarterly TFR. The Bank is not entitled to any deduction on line 4(b) of the tax return, because the Bank had no out-of-state branches and its out-of-state subsidiary had no income for the years at issue, as required by Section 1101(a)(1) of Title 5. The Bank did not claim any other applicable deduction for any of the four tax years. The Bank's taxable income thus is the product of its annual net operating income before taxes and the factor .56, in accordance with Section 1101(a)(2) of Title 5. The calculation table for the tax sets forth the rates specified in Section 1105(a) of Title 5.

2000 Quarter Ending	Income Before Taxes Reported by Bank on TFR		
March 31, 2000	$24,150,000		
June 30, 2000	$38,208,000		
September 30, 2000	$31,564,000		
December 31, 2000	$19,173,000		
2000 Total	$113,095,000		
5 *Del. C.* §1101(a)(2) multiplier	x 0.56		
2000 Taxable Income	$63,333,200		
5 *Del. C.* §1105(a) Calculation Table:			
First $20,000,000 at 8.7%	$1,740,000		
Next $5,000,000 at 6.7%	$335,000		
Next $5,000,000 at 4.7%	$235,000		
Next $620,000,000 at 2.7%	$899,996		
Total 2000 Franchise Tax	**$3,209,996**		
Less: 2000 Franchise Tax Payments	$2,355,000		
2000 Balance due		$854,996	
5 *Del. C.* §1104(c) Late Penalty			
Daily Rate 0.05%	x 0.0005		
Daily Late Penalty	$427.50		
Days Late from 3/1/2001 - 5/20/2005	x 1,541		
Late Penalty on 2000 Balance due		$658,778	
Total 2000 Franchise Tax Balance Due Plus Penalty From 3/1/2001 to 5/20/2005			$1,513,774

2001 Quarter Ending	Income Before Taxes Reported by Bank on TFR		
March 31, 2001	$42,967,000		
June 30, 2001	$45,150,000		
September 30, 2001	$52,361,000		
December 31, 2001	$85,695,000		
2001 Total	$226,173,000		
5 *Del. C.* §1101(a)(2) multiplier	x 0.56		
2001 Taxable Income	$126,656,880		
5 *Del. C.* §1105(a) Calculation Table:			
First $20,000,000 at 8.7%	$1,740,000		
Next $5,000,000 at 6.7%	$335,000		
Next $5,000,000 at 4.7%	$235,000		
Next $620,000,000 at 2.7%	$2,609,736		
Subtotal	$4,919,736		
5 *Del. C.* §1104(c) Additional Tax for Underpayment of Estimated Tax	$16,534 (Ex. 4-11)		
Total 2001 Franchise Tax	**$4,936,270**		
Less: 2001 Franchise Tax Payments	$3,209,860		
2001 Balance Due		$1,726,410	
5 *Del. C.* §1104(c) Late Penalty Daily Rate 0.05% Daily Late Penalty Days Late from 3/1/2002 - 5/20/2005	 x 0.0005 $863.20 x 1,176		
Late Penalty on 2001 Balance Due		$1,015,123	
Total 2001 Franchise Tax Balance Due Plus Penalty from 3/1/2002 to 5/20/2005			$2,741,533

2002 Quarter Ending	Income Before Taxes Reported by Bank on TFR		
March 31, 2002	$85,658,000		
June 30, 2002	$80,566,000		
September 30, 2002	$93,765,000		
December 31, 2002	$146,212,000		
2002 Total	$406,201,000		
5 *Del. C.* §1101(a)(2) multiplier	x 0.56		
2002 Taxable Income	$227,472,560		
5 *Del. C.* §1105(a) Calculation Table:			
First $20,000,000 at 8.7%	$1,740,000		
Next $5,000,000 at 6.7%	$335,000		
Next $5,000,000 at 4.7%	$235,000		
Next $620,000,000 at 2.7%	$5,331,759		
Subtotal	$7,641,759		
5 *Del. C.* §1104(c) Additional Tax for Underpayment of Estimated Tax	$73,595 (Ex. 4-11)		
Total 2002 Franchise Tax	**$7,715,354**		
Less: 2002 Franchise Tax Payments	$4,570,872		
2002 Balance Due		$3,144,482	
5 *Del. C.* §1104(e) Late Penalty Daily Rate 0.05% Daily Late Penalty Days Late from 3/1/2003 - 5/20/2005	 x 0.0005 $1,572.24 x 811		
Late Penalty on 2002 Balance Due		$1,275,087	
Total 2002 Franchise Tax Balance Due Plus Penalty from 3/1/2003 to 5/20/2005			$4,419,569

VI.

I have decided not to exercise my discretion, under Section 1114(a)(1) of Title 5, to abate the franchise tax or penalties I have assessed against the Bank.

Section 1114(a)(1) provides that the Commissioner may abate the unpaid portion of the assessment of any tax or penalty that is "excessive in amount." This statute is copied almost verbatim from Section 6404(a)(1) of the federal Internal Revenue Code. The pertinent regulation under that statute makes clear that the phrase "excessive in amount" refers to an assessment that is "in excess of the correct tax liability." Tr. Reg. 301.6404-1(a). *See also* Tr. Reg. § 301.6404-1(c) ("If more than the correct amount of tax" is assessed, the taxpayer may file a claim for abatement of the over-assessment.)

Under well-settled principles of statutory construction, when a Delaware statute is drawn from an existing statute of another jurisdiction, a strong presumption exists that the legislature intended to adopt the construction of the statute in that other jurisdiction. *Opinion of the Justices,* 181 A.2d 215, 217-218 (Del. 1962); *Hana Ranch, Inc. v. Lent,* 424 A.2d 28, 31 (Del. Ch. 1980). In addition, this construction also conforms to the standard interpretive doctrine that the meaning of particular terms may be ascertained by reference to the words associated with them. 75 *Am. Jur.2d* Statutes § 134; *see also Logan v. Davis,* 191 A.2d 1, 3 (Del. 1963).

Here, the phrase "excessive in amount" is the first in a list that also references taxes assessed erroneously, illegally, or after the limitations period. None of these associated concepts suggest that "excessive" should be given an expansive meaning that includes some general notion of equitable fairness.

Accordingly, I conclude that it would not be appropriate to abate the franchise tax or penalties in this case. I do not agree with the Bank's assertion that taxing all of its income in Delaware is excessive in relation to the activities it conducted and the income it earned in this State, or that the tax and penalties are excessive because the review of the Bank's franchise tax returns for the years at issue did not begin until after March 2003.

CONCLUSION

The Bank's franchise tax assessments for the years at issue, not including penalties, are as follows: $3,209,996 for 2000; $4,936,270 for 2001; $7,715,354 for 2002; and $11,577,586 for 2003. The balance due plus penalties for the years 2000, 2001, 2002 and 2003 amount to $14,515,474, plus penalties of $5,251.74 for each day after May 20, 2005 that these assessments remain unpaid. SO ORDERED.

DATED: May 20, 2005

/s/ Robert A. Glen
Robert A. Glen
State Bank Commissioner

APPENDIX E

5 [Del. Code] § 1101. Tax on net earnings.

(a) A franchise tax is hereby imposed on the "taxable income" of banking organizations and trust companies (computed on a basis that consolidates with the income of such banking organization or trust company for the tax year involved, the income of all subsidiary corporations of such banking organization or trust company in accordance with generally accepted accounting principles; provided, however, that the income of subsidiary corporations of out-of-state banks that operate resulting branches in this State shall be consolidated with the income of such resulting branches only if such subsidiaries make the election provided for in subsection (f) of this section). For the purposes of this chapter, "out-of-state bank" shall have the same meaning as in § 795 of this title. Also for the purposes of this chapter, "resulting branch" shall have the same meaning as in § 795 of this title and, in addition, shall also mean the branch offices in this State of out-of-state banks. The "taxable income" on which such tax is imposed shall be equal to the product of (1) and (2) as follows:

(1) Net operating income before taxes increased by the amount of securities gains before taxes plus, in the case of a banking organization that is a resulting branch in this State of an out-of-state bank, the resulting branch imputed capital addback determined under subsection (i) of this section and reduced by:

a. Securities losses before taxes;

b. That portion of net operating income before taxes, verifiable by documentary evidence, from any subsidiary or foreign branch established within the United States pursuant to § 771 of this title or other branch established within the United States but outside of this State pursuant to federal law or other applicable law of this State which is:

1. Otherwise subject to income taxation under Delaware law;

2. Derived from business activities carried on outside the State and subject to income taxation under the laws of another state, and that portion of net operating income before taxes from any such entity other than a Delaware-chartered banking organization or a national bank located in this State (as defined in § 801(5) of this title) which entity is a banking organization and which is subject to income taxation under the laws of another state; provided, however, that in the case of any subsidiary engaged in the sale, distribution or underwriting of, or dealing in, securities, the amount of income excluded pursuant to this subsubparagraph b.2. shall in no event exceed 50 percent of such subsidiary's net operating income before taxes; or

3. Derived from business activities carried on outside the State, which subsidiary, foreign branch or other branch

established outside of this State is subject to shares tax under the laws of another state; provided however, that in the case of any subsidiary engaged in the sale, distribution or underwriting of or dealing in securities, the amount of income excluded pursuant to this subsubparagraph shall in no event exceed 50 percent of such subsidiary's net operating income before taxes;

c. Net operating income before taxes as shown on the books of account of any non-United States branch office established: (i) Pursuant to § 771 of this title in the case of a state banking organization; or (ii) pursuant to federal law in the case of a national bank; provided that in either case at least 80 percent of the gross income of such non-United States branch office constitutes "income from sources without the United States" as defined under § 862(a) of the Internal Revenue Code of 1986, as amended [26 U.S.C. § 862(a)], or any successor provisions thereto;

d. The gross income derived from international banking transactions (as defined in § 101 of this title) after subtracting therefrom any expenses or other deductions attributable thereto;

e. The gross income of an international banking facility (as defined in § 101 of this title) less any expenses or other deductions attributable thereto;

f. The interest income from obligations of volunteer fire companies;

g. Any examination fee paid to the Office of the State Bank Commissioner pursuant to § 127(a) of this title.

(2) Multiplied by the factor .56.

For purposes of this subsection, a resulting branch in this State of an out-of-state bank or foreign bank, or a foreign bank branch, foreign bank limited purpose branch, foreign bank agency or a federal branch or agency (all as defined in § 101 of this title) shall be treated as if it were a corporation. The Commissioner shall prescribe such rules and regulations as may be deemed necessary in order that the tax liability of any resulting branch in this State of an out-of-state bank or foreign bank, or any foreign bank branch, foreign bank limited purpose branch, foreign bank agency or federal branch or agency under this subsection may be returned, determined, computed, assessed, collected and adjusted, in such manner as to clearly reflect the tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

(b) A franchise tax is hereby imposed on the "taxable income" of federal savings banks not headquartered in this State but maintaining branches in this State, verifiable by documentary evidence. The "taxable income" on which tax is imposed shall be equal to the net operating income of the branch or

branches located in Delaware before taxes increased by the amount of securities gains before taxes and reduced by the amount of securities losses before taxes and by the interest income from obligations of volunteer fire companies.

* * *

APPENDIX F

[LOGO] *ERNST &YOUNG* ■ Ernst & Young LLP

FACTUAL SUPPORT MEMO FOR LEHMAN BROTHERS BANK, FSB DELAWARE FRANCHISE TAX AMENDED RETURNS PREPARED BY ERNST & YOUNG LLP

Lehman Brothers Bank, FSB, engaged Ernst & Young LLP to prepare the attached (see Attachments 1-4) amended Delaware Bank Franchise tax returns for the tax periods of 2000-2003 utilizing the separate accounting method of computing Delaware taxable income. That is, generally, income was sourced where earned and expenses were sourced where incurred. When a clear method of allocation was not apparent, income was sourced 100% to Delaware. This memo serves as the factual support for the amended returns.

Background Facts

Lehman Brothers Bank, FSB (the "Bank"), which is a federally chartered stock savings bank, maintains its Executive Offices in New York. For the calendar years 2000-2003, the Bank provided services related to the following: demand deposit accounts, certificates of deposits ("CDs"), individual savings accounts, individual mortgage loans, commercial revolving loans, commercial mortgage loans, trusts, subsidiary lines of credit and securities and investments in Federal Home Loan Bank stock. Interest income on loans constituted 97% of the Bank's gross income.

Per the Delaware Branch general ledger, activities/ services specific to Delaware were:

(In Number of Accounts as of 12/31)	2000	2001	2002	2003
Demand Deposit Accounts	1,877	2,342	2,559	2,727
CDs	894	554	424	381
Savings Accounts	380	293	290	218
Revolving Loans	3	2	2	2
Commercial Mortgage Loans	0	0	0	0
Trusts	0	0	2	10
Sub. LOC	1	2	2	2
Consumer Loans	37	28	12	8
Old DSB Mortgages	442	178	106	25

Note: Prior to April of 2000, the Banks portfolio of individual mortgages was higher. However, the majority of these loans were sold to third parties or subsidiaries in April, 2000 and are no longer assets of the Bank.

Customers have access to banking services on the Internet. Some of the Internet services available are; online bill pay, opening accounts, and account transfer requests.

The Bank had 13 employees who worked in Delaware, either in full or in part, at year-end 2000, 12 at year-end 2001, 12 at year-end 2002, and 11 at year-end 2003. The employees in Delaware had the following job titles during the calendar periods of 2000-2003: Accounts Payable Clerk, Receptionist, Human

Resources Administrator, Marketing Manager, Accountant, Project Coordinator, Servicing Manager, Assistant Controller, Analyst – Jr., MIS Specialist, Senior Trust Officer, Asset Manager Supervisor, Branch Manager, Senior Vice-President, Teller.

Delaware Activities – 2000-2003

The activities performed in Delaware are summarized in the following paragraphs.

Call Center: The call center activity was previously outsourced to Teletek and was not brought in house until June 2003. Questions and requests regarding transactions and services available on the Internet are handled by some of the Delaware personnel (the tellers, receptionist and accounts payable clerk). Customer calls and emails average between 640-760/month and 300-400/month, respectively. Examples of requests or questions handled by the representatives, include PIN resets, check copy requests and debit card questions. All questions regarding home mortgages or home equity loans are referred to Aurora Loan Services, Inc. ("Aurora") located in Denver, Colorado.

Accounts Payable: The coding for the majority of the Bank's check requisitions, other than items related to occupancy or payroll, is performed in Delaware and then sent to New York for processing. In some cases where the vendor is located in Delaware, the Delaware personnel may code and process the check requisition.

2003 Quarter Ending	Income Before Taxes Reported by Bank on TFR		
March 31, 2003	$160,485,000		
June 30, 2003	$168,406,000		
September 30, 2003	$176,540,000		
December 31, 2003	$161,076,000		
2003 Total	$666,507,000		
5 *Del. C.* §1101(a)(2) multiplier	x 0.56		
2003 Taxable Income	$373,243,920		
5 *Del. C.* §1105(a) Calculation Table:			
First $20,000,000 at 8.7%	$1,740,000		
Next $5,000,000 at 6.7%	$335,000		
Next $5,000,000 at 4.7%	$235,000		
Next $620,000,000 at 2.7%	$9,267,586		
Total 2003 Franchise Tax	**$11,577,586**		
Less: 2003 Franchise Tax Payments	$6,800,000		
2003 Balance Due		$4,777,586	
5 *Del. C.* §1104(e) Late Penalty Daily Rate 0.05% Daily Late Penalty Days Late from 3/1/2004 - 5/20/2005	 x 0.0005 $2,388.79 x 445		
Late Penalty on 2003 Balance Due		$1,063,012	
Total 2003 Franchise Tax Balance Due Plus Penalty from 3/1/2004 to 5/20/2005			$5,840,598
Total 2000-2003 Franchise Tax Balance due Plus Penalties from 3/1/2001 to 5/20/2005			**$14,515,474**

Late Penalty from 5/20/2005

2000 Franchise Tax Balance Due	$854,996	
2001 Franchise Tax Balance Due	$1,726,410	
2002 Franchise Tax Balance Due	$3,144,482	
2003 Franchise Tax Balance Due	$4,777,586	
Total	$10,503,474	
5 *Del. C.* §1104(e) Late Penalty (Daily Rate 0.05%)	x 0.0005	
Daily Late Penalty from 5/20/2005		**$5,251.74**

The check requisitions for the Sotheby's joint venture are prepared and processed by Delaware Personnel. This service started in 2001. There is a general administration fee of $2,000/month which Sotheby pays the Bank for accounting, accounts payable and cash settlement services.

Human Resources: Human resource activity, excluding payroll processing, for Delaware branch personnel is performed in Delaware.

Trusts: The establishment, administration, and disbursement for the Bank's trust business are conducted by Delaware. The Bank's trust business began in 2002.

Community Reinvestment Activity: The Delaware personnel will from time to time run promotional campaigns for the local branch CRA activities. Additionally, local Community Reinvestment Activities ("CRA") are attended or performed by local personnel. National CRA activity is either originated or purchased outside of Delaware.

Cash Accounting/settlement: The cash accounting and cash settlements for the Bank's Federal Home Loan Bank ("FHLB") and Federal Reserve accounts are handled in DE. A residual balance is left in the FHLB and Federal Reserve Accounts to cover branch activity. The FHLB account generates approximately $2,000/month in interest. There is no interest paid on the Federal Reserve account. Any excess cash remains in the FHLB account until the end of the business day when it is wired to the Bank's J.P.

Morgan Chase account. There are no fees charged for this service.

The Delaware Branch handles the cash settlements for the subsidiary's Sotheby's Joint Venture and Financial Freedom. The fees received for this service are included in the general administrative fee noted above.

Federal Line Wires: Requests by customers for wire transfers, ATM services, requests by Financial Freedom (a subsidiary) customers for wire transfers, and any other services needing a federal line are handled in Delaware.

Provident Bank Services: The personnel in Delaware receive a fee for processing loans and mortgages for Provident Bank ("Provident"). The loans originate in the Bank's name but are sold to Provident at the end of each month. Provident personnel approve the loans and mortgages.

Mortgage services: Post April 2000, there are no longer any loans that the Bank services. Aurora now performs these services.

Technology: The maintenance of Sanchez, the system which manages the Bank's website and back-end core accounts was previously performed in Delaware. Technology services have been handled in New York since 2002.

Asset Management: Prior to April of 2000, the collection functions for the loans originated in Delaware were performed in Delaware. After April of 2000

when the majority of the loans were sold, this function transferred to Aurora.

Office of Thrift Supervision Reporting: The Delaware personnel prepare the Bank's regulatory reports. However, most interaction with the Office of Thrift Supervision ("OTS") takes place in New York. No fee is charged for this service.

Branch Facilitation Costs: The Delaware branch incurs various costs and fees in connection with its status as a branch office for regulatory purposes. The branch status enables the Bank to access FHLB funding and to accept and maintain deposits. Such costs and fees include FDIC premiums, OTS assessments, occupancy costs, and consulting costs, amongst others. In order to adequately compensate the Delaware branch for such costs and related services, transfer-pricing standards indicate that a cost plus 5-10% arrangement is proper. Accordingly, the Delaware branch's income numbers included within this memorandum incorporate a fee based upon 110% of appropriate costs.

Financial Information
NOTE: Following general ledger presentation of debits and credits, income reflected in the following summaries and attached exhibits is presented in ( ), losses are not.

2000

The Bank's consolidated calendar-year income before taxes for 2000 was 135,893,547 (see Exhibit 1). Of this amount, the activities in Delaware account for $9,245,346 of the income. (see Exhibit 2) A summarized (income)/loss statement for the Delaware Branch consists of:

Revenues	
Interest Income	$ (9,148,478)
Interest Expense	7,742,445
Net Interest Margin	$ (1,406,033)
Other (Income)/Expense Net of Contra Revenues*	$ (9,372,035)
Net (revenue)/expense	$ (10,778,068)
Operating Expenses	
Personnel Expenses	$ 429,247
Non-Personnel Expenses	1,103,475
Total Expenses	$ 1,532,722
(Income)/Loss Before Taxes	$ (9,245,346)

*This contra account contains the fees charged the Bank by the OTS and FDIC.

2001

The Bank's consolidated calendar-year income before taxes for 2001 (see Exhibit 1) was $211,751,242. Of this amount, the activities in Delaware account for $3,470,998 of the income (see Exhibit 3). The (income)/loss statement for the Delaware Branch consists of:

Revenues		
Interest Income	$	(2,847,924)
Interest Expense		5,693,867
Net Interest Margin	$	2,845,943
Other (Income)/Expense Net of Contra Revenues*	$	(7,205,708)
Net (Revenue)/Expense	$	(4,359,765)
Operating Expenses		
Personnel Expenses	$	244,708
Non-Personnel Expenses		644,070
Total Expenses	$	888,778
(Income)/Loss Before Taxes	$	(3,470,998)

*This contra account contains the fees charged the Bank by the OTS and FDIC.

2002

The Bank's consolidated calendar-year income before taxes for 2002 (see Exhibit 1) was $363,796,252. Of this amount, the activities in Delaware account for $8,065,575 of the income (see Exhibit 4). The (income)/loss statement for the Delaware Branch consists of:

Revenues		
Interest Income	$	(2,035,346)
Interest Expense		1,208,491
Net Interest Margin	$	(826,855)
Other (Income)/Expense Net of Contra Revenues*	$	(7,972,516)
Net (Revenue)/Expense	$	(8,799,371)
Operating Expenses		
Personnel Expenses	$	215,256
Non-Personnel Expenses		518,541
Total Expenses	$	733,796
(Income)/Loss Before Taxes	$	(8,065,575)

*This contra account contains the fees charged the Bank by the OTS and FDIC.

2003

The Bank's consolidated calendar-year income before taxes for 2003 (see Exhibit 1) was $671,469,796. Of this amount, the activities in Delaware account for $8,600,649 of the income (see Exhibit 5). The (income) loss statement for the Delaware Branch consists of:

Revenues		
Interest Income	$	(1,909,985)
Interest Expense		701,186
Net Interest Margin	$	(1,208,799)
Other (Income)/Expense Net of Contra Revenues*	$	(8,133,387)
Net (Revenue)/Expense	$	(9,342,186)
Operating Expenses		
Personnel Expenses	$	200,318
Non-Personnel Expenses		541,219
Total Expenses	$	741,537
(Income)/Loss Before Taxes	$	(8,600,649)

*This contra account contains the fees charged the Bank by the OTS and FDIC.

/s/ Christine Gustafson
Christine Gustafson
Principal

August 27, 2004

AMENDED ATTACHMENT 1

5 DE Admin. Code 1100 Banking 5 DE Admin. Code 1100

1108 Final Franchise Tax Report Federal Savings Banks Not Headquartered in Delaware 5 Del. C. Ch. 11

Formerly Regulation No.: 5.1101etal.0007
Effective Date: September 11, 2001

This report shall be completed by any federal savings bank not headquartered in this State but maintaining branches in this State and submitted to the Office of the State Bank Commissioner on or before January 30. Income reported is for the previous calendar year. Instructions for the preparation of this report are found in Regulation 1106 (formerly 5.1101etal.0005).

190a

Lehman Brothers Bank FSB
Name of Federal Savings Bank

2000
Tax Year

70 Hudson St. – 10th Fl. – Corp. Tax Dept.
Jersey City, NJ 07302
Location

51-0073416
Federal Employer Identification Number

Rounded to the nearest thousand $

1.	Net Operating Income Before Taxes verifiable by documentary evidence – as computed on a separate accounting basis	9,245,000
2.	Less: Interest income from obligations of volunteer fire companies	
3.	Taxable income before taxes (subtract item 2 from item 1)	9,245,000
4.	Subtotal annual franchise tax liability (before tax credits)	
	Calculation Table:	
	First $20,000,000 of item 3 at 8.7%	804,315
	Next $ 5,000,000 of item 3 at 6.7%	
	Next $ 5,000,000 of item 3 at 4.7%	
	Next $620,000,000 of item 3 at 2.7%	
	Amount of item 3 over $650,000,000 at 1.7%	
	Subtotal	804,315
5.	Less: Total employment tax credits (calculated in accordance with Regulation 1109 (formerly Regulation No. 5.1105.0008), completed worksheet attached hereto)	
6.	Less: Travelink tax credits (calculated in accordance with Department of Transportation Travelink tax credit reporting requirements, completed worksheet attached hereto)	
7.	Less: Historic Preservation Tax Credits (calculated in accordance with the Office of Historic Preservation tax credit reporting requirements. Certificate of Completion attached. Certificate of Transfer attached if credits have been transferred, sold or assigned to the taxpayer by another person.)	

8.	Total annual franchise tax liability (subtract items 5, 6 and 7 from item 4)		804,315
9.	Less: Estimated tax payments		
a.	June 1 payment		$ 23,000
b.	September 1 payment		23,000
c.	December 1 payment		23,000
d.	Total estimated tax payments (add items 9a, 9b and 9c)	plus $2,286,000 paid with original return	2,355,000
10.	March 1 final tax payment or (refund) (subtract item 9d from item 8)		(1,550,685)
11.	Additional tax due to underpayment of estimated franchise tax or installment (if applicable)		
12.	Penalty for late payment of final franchise tax (if applicable)		
13.	Total final tax payment or (refund) (add items 10,11 and 12)		$(1,550,685)

I, the undersigned officer, hereby certify that this report, including any accompanying schedules and statements, has been prepared in conformance with the appropriate instructions and is true and correct to the best of my knowledge and belief.

	/s/ Anthony Taranto	SR.VP
Date	Signature of President, Treasurer or Other Proper Officer	Title
	Anthony Taranto	212-526-7451
	Print Name	Phone No.

Lehman Brothers Holdings, Inc.
70 Hudson St. – 10th Floor – Corp. Tax
Jersey City, NJ 07302
Print Address

Mail Completed Form To:
Office of the State Bank Commissioner
555 E. Loockerman Street, Suite 210
Dover, DE 19901

See 5 DE Reg. 660 (09/01/01)

1108 Final Franchise Tax Report Federal Savings Banks Not Headquartered in Delaware 5 Del. C. Ch. 11

Formerly Regulation No.: 5.1101etal.0007
Effective Date: September 11, 2001

This report shall be completed by any federal savings bank not headquartered in this State but maintaining branches in this State and submitted to the Office of the State Bank Commissioner on or before January 30. Income reported is for the previous calendar year. Instructions for the preparation of this report are found in Regulation 1106 (formerly 5.1101etal.0005).

Lehman Brothers Bank FSB Name of Federal Savings Bank	2001 Tax Year
70 Hudson Street – 10th Floor Jersey City, NJ 07302 Location	51-0073416 Federal Employer Identification Number
	Rounded to the nearest thousand $

1.	Net Operating Income Before Taxes verifiable by documentary evidence – as computed on a separate accounting basis	3,471,000
2.	Less: Interest income from obligations of volunteer fire companies	
3.	Taxable income before taxes (subtract item 2 from item 1)	3,471,000
4.	Subtotal annual franchise tax liability (before tax credits)	
	Calculation Table:	
	First $20,000,000 of item 3 at 8.7%	301,977
	Next $ 5,000,000 of item 3 at 6.7%	
	Next $ 5,000,000 of item 3 at 4.7%	
	Next $620,000,000 of item 3 at 2.7%	
	Amount of item 3 over $650,000,000 at 1.7%	
	Subtotal	301,977
5.	Less: Total employment tax credits (calculated in accordance with Regulation 1109 (formerly Regulation No. 5.1105.0008), completed worksheet attached hereto)	
6.	Less: Travelink tax credits (calculated in accordance with Department of Transportation Travelink tax credit reporting requirements, completed worksheet attached hereto)	
7.	Less: Historic Preservation Tax Credits (calculated in accordance with the Office of Historic Preservation tax credit reporting requirements. Certificate of Completion attached. Certificate of Transfer attached if credits have been transferred, sold or assigned to the taxpayer by another person.)	

8.	Total annual franchise tax liability (subtract items 5, 6 and 7 from item 4)		301,977
9.	Less: Estimated tax payments		
	a. June 1 payment		$ 950,000
	b. September 1 payment		950,000
	c. December 1 payment		950,000
	d. Total estimated tax payments (add items 9a, 9b and 9c)	plus $359,860 paid with original return	3,209,860
10.	March 1 final tax payment or (refund) (subtract item 9d from item 8)		(2,907,883)
11.	Additional tax due to underpayment of estimated franchise tax or installment (if applicable)		
12.	Penalty for late payment of final franchise tax (if applicable)		
13.	Total final tax payment or (refund) (add items 10,11 and 12)		$ (2,907,883)

I, the undersigned officer, hereby certify that this report, including any accompanying schedules and statements, has been prepared in conformance with the appropriate instructions and is true and correct to the best of my knowledge and belief.

Date	/s/ Anthony Taranto Signature of President, Treasurer or Other Proper Officer	SR.VP Title
	Anthony Taranto Print Name	212-526-7451 Phone No.

Lehman Brothers Holdings, Inc.
70 Hudson St. – 10th Floor
Jersey City, NJ 07302
Print Address

Mail Completed Form To:
Office of the State Bank Commissioner
555 E. Loockerman Street, Suite 210
Dover, DE 19901

See 5 DE Reg. 660 (09/01/01)

1108 Final Franchise Tax Report Federal Savings Banks Not Headquartered in Delaware 5 Del. C. Ch. 11

Formerly Regulation No.: 5.1101etal.0007
Effective Date: September 11, 2001

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Lehman Brothers Bank FSB Name of Federal Savings Bank	2002 Tax Year
70 Hudson Street – 10th Floor Jersey City, NJ 07302 Location	51-0073416 Federal Employer Identification Number
	Rounded to the nearest thousand $
1. Net Operating Income Before Taxes verifiable by documentary evidence – as computed on a separate accounting basis	8,066,000
2. Less: Interest income from obligations of volunteer fire companies	
3. Taxable income before taxes (subtract item 2 from item 1)	8,066,000
4. Subtotal annual franchise tax liability (before tax credits)	
Calculation Table:	
First $20,000,000 of item 3 at 8.7%	701,742
Next $ 5,000,000 of item 3 at 6.7%	
Next $ 5,000,000 of item 3 at 4.7%	
Next $620,000,000 of item 3 at 2.7%	
Amount of item 3 over $650,000,000 at 1.7%	
Subtotal	701,742
5. Less: Total employment tax credits (calculated in accordance with Regulation 1109 (formerly Regulation No. 5.1105.0008), completed worksheet attached hereto)	
6. Less: Travelink tax credits (calculated in accordance with Department of Transportation Travelink tax credit reporting requirements, completed worksheet attached hereto)	
7. Less: Historic Preservation Tax Credits (calculated in accordance with the Office of Historic Preservation tax credit reporting requirements. Certificate of Completion attached. Certificate of Transfer attached if credits have been transferred, sold or assigned to the taxpayer by another person.)	

8.	Total annual franchise tax liability (subtract items 5, 6 and 7 from item 4)		701,742
9.	Less: Estimated tax payments		
a.	June 1 payment		$ 1,400,000
b.	September 1 payment		1,060,000
c.	December 1 payment		900,000
d.	Total estimated tax payments (add items 9a, 9b and 9c)	plus $1,210,880 paid with Amended return	4,570,880
10.	March 1 final tax payment or (refund) (subtract item 9d from item 8)		(3,869,138)
11.	Additional tax due to underpayment of estimated franchise tax or installment (if applicable)		
12.	Penalty for late payment of final franchise tax (if applicable)		
13.	Total final tax payment or (refund) (add items 10,11 and 12)		$ (3,869,138)

I, the undersigned officer, hereby certify that this report, including any accompanying schedules and statements, has been prepared in conformance with the appropriate instructions and is true and correct to the best of my knowledge and belief.

	/s/ Anthony Taranto	SR.VP
Date	Signature of President, Treasurer or Other Proper Officer	Title
	Anthony Taranto	212-526-7451
	Print Name	Phone No.

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1108 Final Franchise Tax Report Federal Savings Banks Not Headquartered in Delaware 5 Del. C. Ch. 11

Formerly Regulation No.: 5.1101etal.0007
Effective Date: September 11, 2001

This report shall be completed by any federal savings bank not headquartered in this State but maintaining branches in this State and submitted to the Office of the State Bank Commissioner on or before January 30. Income reported is for the previous calendar year. Instructions for the preparation of this report are found in Regulation 1106 (formerly 5.1101etal.0005).

Lehman Brothers Bank FSB Name of Federal Savings Bank	2003 Tax Year
70 Hudson Street – 10th Floor Jersey City, NJ 07302 Location	51-0073416 Federal Employer Identification Number
	Rounded to the nearest thousand $

1.	Net Operating Income Before Taxes verifiable by documentary evidence – as computed on a separate accounting basis	8,601,000
2.	Less: Interest income from obligations of volunteer fire companies	
3.	Taxable income before taxes (subtract item 2 from item 1)	8,601,000
4.	Subtotal annual franchise tax liability (before tax credits)	
	Calculation Table:	
	First $20,000,000 of item 3 at 8.7%	748,287
	Next $ 5,000,000 of item 3 at 6.7%	
	Next $ 5,000,000 of item 3 at 4.7%	
	Next $620,000,000 of item 3 at 2.7%	
	Amount of item 3 over $650,000,000 at 1.7%	
	Subtotal	748,287
5.	Less: Total employment tax credits (calculated in accordance with Regulation 1109 (formerly Regulation No. 5.1105.0008), completed worksheet attached hereto)	
6.	Less: Travelink tax credits (calculated in accordance with Department of Transportation Travelink tax credit reporting requirements, completed worksheet attached hereto)	
7.	Less: Historic Preservation Tax Credits (calculated in accordance with the Office of Historic Preservation tax credit reporting requirements. Certificate of Completion attached. Certificate of Transfer attached if credits have been transferred, sold or assigned to the taxpayer by another person.)	

8.	Total annual franchise tax liability (subtract items 5, 6 and 7 from item 4)		748,287
9.	Less: Estimated tax payments		
	a. June 1 payment	$	4,800,000
	b. September 1 payment		1,000,000
	c. December 1 payment		1,000,000
	d. Total estimated tax payments (add items 9a, 9b and 9c)*		6,800,000
10.	March 1 final tax payment or (refund) (subtract item 9d from item 8)		(6,051,713)
11.	Additional tax due to underpayment of estimated franchise tax or installment (if applicable)		
12.	Penalty for late payment of final franchise tax (if applicable)		
13.	Total final tax payment or (refund) (add items 10,11 and 12)	$	(6,051,713)

* Original return reflected a refund due of $4,258,842 which was never received.

I, the undersigned officer, hereby certify that this report, including any accompanying schedules and statements, has been prepared in conformance with the appropriate instructions and is true and correct to the best of my knowledge and belief.

Date	/s/ Anthony Taranto Signature of President, Treasurer or Other Proper Officer	SR.VP Title
	Anthony Taranto Print Name	212-526-7451 Phone No.

Lehman Brothers Holdings, Inc.
70 Hudson St. – 10th Floor Corp. Tax
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Mail Completed Form To:
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555 E. Loockerman Street, Suite 210
Dover, DE 19901

See 5 DE Reg. 660 (09/01/01)

EXHIBIT 2

Lehman Brothers Bank
Delaware Branch Separate Accounting

	2000
Revenue:	
Interest Income:	
Interest Income – Sotheby/Lehman Mortgage Services Line of Credit	(121,293)
Interest Income – Loans Originated by Delaware Savings Bank (8-month period prior to transfer)	(1,106,566)
Net Interest Income – FHLB Dividends	(700,247)
Feed from MTS – Ledger AWE, 51500	(5,497,300)
Interest Income – Mortgages Originated by Delaware Savings Bank (4-month period after transfer to Aurora)	(1,666,973)
Miscellaneous	(56,100)
Total Interest Income	(9,148,478)
Interest Expense:	
Interest Expense – Interest Paid on Customer Deposit Accts	7,742,445
Total Interest Expense	7,742,445
Net Interest Margin	(1,406,033)
Other (Income)/Expense:	
Net Fees & Expense – Customer Deposits	(40,461)
Purchase Mortgage Servicing Rights Amortization	5,319
FDIC Premium	396,394
OTS Assessment	539,225
SLMS Accounting Services	(2,000)
Mtg. Loan Fees/Expense/Loss on sale	1,133,961
Feed from MTS – Ledger AWE, 51000 (offset in 2001)	(1,500,818)
Feed from MTS (offset in 2001)	(91,877)
Gain on the Sale of Delaware Condo	(52,451)
Miscellaneous	43,848
FHLB Stock Dividends	(7,088,000)
Branch Facilitation Fee	(2,715,175)
Total Other (Income)/Expense	(9,372,035)
Net (Revenues)/Expense	(10,778,068)

1998

Expense:		429,247
Personnel	**PE**	429,247
Occupancy Allocation		64,312
Legal Fees & Settlements		–
Fixed Asset Interest		681
Mail/Print/Supp/Rec Retent/Rep		98,550
Market Data		–
Non Real Time Data & Sub		6,555
Communication		43,002
Technology		106,656
System Consultants		–
T & E		73,020
Advertising		32,248
Occupancy		285,746
Accounting/Audit		92,235
EXPAT/RELOCATION COSTS		–
Consulting Services		266,426
Temps		14,787
Recruiting		–
Training		1,335
Other		42,939
Legal Advisory		(25,000)
Corporate Events		(16)
Variable Expenses		–
Total NPE		1,103,475
	Total Expenses	1,532,722
	(Income)/Loss before taxes	**(9,245,346)**

EXHIBIT 3

Lehman Brothers Bank
Delaware Branch Separate Accounting

	2001
Revenue:	
Interest Income:	
Interest Income – Financial Freedom & Sotheby/Lehman Mortgage Services Lines of Credit	(785,731)
Interest Income – Loans Originated by Delaware Savings Bank	(117,472)
Net Interest Income – FHLB Dividends	(129,389)
Interest Income – Mortgages Originated by Delaware Savings Bank Transferred – 4/00	(1,813,296)
Miscellaneous	(2,036)
Total Interest Income	(2,847,924)
Interest Expense:	
Interest Expense – Interest Paid on Customer Deposit Accts	5,693,867
Total Interest Expense	5,693,867
Net Interest Margin	2,845,943
Other (Income)/Expense:	
Net Fees & Expense – Customer Deposits	(4,226)
ATM & Interchange Income	(634)
Purchase Mortgage Servicing Rights Amortization	27,190
FDIC Premium	471,481
OTS Assessment	1,013,149
SLMS Accounting Services	(22,000)
LBB share of SLMS net income	(25,390)
Feed from MTS – Ledger AWE, 51000 (offset of 2000 amt.)	1,500,818
Loss on sale of assets (Prices Corner, misc fixed assets)	201,867
Loss on Loan Sales – Wendover	7,778
Adj. GL to Flash (offset in 2001)	(81,320)
Feed from MTS (offset of 2000 amt)	91,877
Miscellaneous	19,451
FHLB Stock Dividends	(7,795,000)
Branch Facilitation Fee	(2,610,748)
Total Other (Income)/Expense	(7,205,708)
Net (Revenues)/Expense	(4,359,765)

Expense:		244,708
Personnel	**PE**	244,708
Occupancy Allocation		100,644
Legal Fees & Settlements		–
Fixed Asset Interest		376
Mail/Print/Supp/Rec Retent/Rep		35,682
Market Data		–
Non Real Time Data & Sub		2,022
Communication		74,871
Technology		212,908
System Consultants		–
T & E		32,241
Advertising		14,100
Occupancy		70,624
Accounting/Audit		8,989
Consulting Services		(4,456)
Temps		31
Recruiting		–
Training		1,625
Other		75,528
Legal Advisory		18,546
Corporate Events		340
Variable Expenses		–
Total NPE		644,070
	Total Expenses	888,778
	(Income)/Loss before taxes	**(3,470,987)**

EXHIBIT 4

Lehman Brothers Bank
Delaware Branch Separate Accounting

	2002
Revenue:	
Interest Income:	
Interest Income – Financial Freedom & Sotheby/Lehman Mortgage Services Lines of Credit	(1,314,246)
Interest Income – Loans Originated by Delaware Savings Bank	(31,068)
Net Interest Income – FHLB Dividends	(43,240)
Interest Income – Mortgages Originated by Delaware Savings Bank Transferred – 4/00	(646,793)
Total Interest Income	(2,035,347)
Interest Expense:	
Interest Expense – Interest Paid on Customer Deposit Accts	1,208,491
Total Interest Expense	1,208,491
Net Interest Margin	(826,855)
Other Income:	
Net Fees & Expense – Customer Deposits	(3,847)
ATM & Interchange Income	(19,902)
Purchase Mortgage Servicing Rights Amortization	28,372
FDIC Premium	457,450
OTS Assessment	1,342,893
SLMS Accounting Services	(24,000)
LBB share of SLMS net income	(184,039)
Gain on Loan Sales – Wendover	(12,747)
Adj. GL to Flash (offset in 2001 amt.)	81,320
Miscellaneous	(462)
FHLB Stock dividends	(7,340,000)
Trust Activities	490,000
Branch Facilitation Fee	(2,787,553)
Total Other (Income)/Expense	(7,972,516)
Net (Revenues)/Expense	(8,799,371)

Expense:		215,256
Personnel	PE	215,256
Occupancy Allocation		–
Legal Fees & Settlements		–
Fixed Asset Interest		–
Mail/Print/Supp/Rec Retent/Rep		24,244
Market Data		–
Non Real Time Data & Sub		2,664
Communication		37,745
Technology		292,265
System Consultants		–
T & E		20,275
Advertising		–
Occupancy		34,554
Accounting/Audit		–
Consulting Services		3,594
Temps		–
Recruiting		–
Training		3,558
Other		99,643
Legal Advisory		–
Corporate Events		–
Variable Expenses		–
Total NPE		518,541
	Total Expenses	733,796
	(Income)/Loss before taxes	**(8,065,575)**

EXHIBIT 5

Lehman Brothers Bank
Delaware Branch Separate Accounting

	2003
Revenue:	
Interest Income – Financial Freedom & Sotheby/Lehman Mortgage Services Lines of Credit & Notes	(1,533,671)
Interest Income – Loans Originated by Delaware Savings Bank	(33,630)
Net Interest Income – FHLB Dividends	(9,190)
Interest Income – Mortgages Originated by Delaware Savings Bank Transferred – 4/00	(333,494)
Total Interest Income	(1,909,985)
Interest Expense:	
Interest Expense – Interest Paid on Customer Deposit Accts	701,186
Total Interest Expense	701,186
Net Interest Margin	(1,208,799)
Other (Income)/Expense:	
Net Fees & Expense – Customer Deposits	(1,267)
ATM & Interchange Income	(21,667)
Purchase Mortgage Servicing Rights Amortization	25,104
FDIC Premium	1,710,268
OTS Assessment	1,791,403
SLMS Accounting Services	(24,000)
LBB share of SLMS net income	(314,909)
Miscellaneous	(791)
FHLB Stock Dividends	(6,478,000)
Trust activity	(152,000)
Branch Facilitation Fee	(4,667,530)
Total Other (Income)/Expense	(8,133,387)
Net (Revenues)/Expense	(9,342,186)

Expense:		200,318
Personnel	**PE**	200,318
Occupancy Allocation		–
Legal Fees & Settlements		–
Fixed Asset Interest		242
Mail/Print/Supp/Rec Retent/Rep		32,950
Market Data		..
Non Real Time Data & Sub		2,018
Communication		44,615
Technology		289,450
System Consultants		–
T & E		12,805
Occupancy		22,854
Accounting/Audit		–
Consulting Services		8,104
Temps		–
Recruiting		2,433
Training		2,928
Other		121,566
Legal Advisory		–
Security		1,257
Advertising		–
Corporate Events		(10)
Variable Expenses		8
Total NPE		541,219
	Total Expenses	741,537
	(Income)/Loss before taxes	(8,600,649)

APPENDIX G

PRICEWATERHOUSECOOPERS [LOGO]

PricewaterhouseCoopers LLP's Separate Accounting Review Of Lehman Brothers Bank, FSB's Delaware Operations

This report both summarizes the procedures performed by PricewaterhouseCoopers LLP ("PricewaterhouseCoopers") to confirm the accuracy and reasonableness of Ernst and Young's ("E&Y") separate accounting methodology and our conclusions with respect thereto. E&Y used the separate accounting methodology to prepare Lehman Brothers Bank, FSB's (the "Bank") amended Delaware Bank Franchise Tax returns for 2000-2003 and its factual support memorandum (the "Factual Support Memorandum").

Executive Summary

As described in greater detail below, the Bank sourced 50% of its taxable income to Delaware on its 2000-2002 Delaware Bank Franchise Tax Returns. This return position was conservative from a separate accounting perspective because on average 98% of the Bank's income was earned outside Delaware.

In 2003, Delaware challenged the Bank's filing methodology, asserting that 100% of its income was subject to the Delaware Bank Franchise Tax because the Bank did not have a "branch" outside of Delaware. In response to Delaware's challenge, the Bank amended its 2000-2003 Delaware Bank Franchise Tax returns.

In the amended returns, Delaware taxable income was computed utilizing a separate accounting analysis. This resulted in an allocation of the Bank's income to Delaware as follows: 6.8% in 2000, 1.6% in 2001, 2.2% in 2002, and 1.3% in 2003.

In May of 2004, PricewaterhouseCoopers was engaged to review and confirm the accuracy and reasonableness of E&Y's Factual Support Memorandum that corroborated the methodology used to file the amended Delaware Bank Franchise Tax Returns for 2000-2003. As described in greater detail below, the allocation of income and expenses to Delaware in E&Y's Factual Support Memorandum is accurate and reasonable from a separate accounting perspective.

Background

The Bank is a federally chartered stock savings bank and maintains its executive offices in New York. The Bank holds its board meetings in New York and decision making for the majority of the Bank's business is conducted outside of Delaware.

For the calendar years 2000-2003, the Bank provided services related to the following: demand deposit accounts; certificates of deposits ("CDs"); individual savings accounts; individual mortgage loans; commercial revolving loans; commercial mortgage loans; trusts; subsidiary letters of credit; and investments in Federal Home Loan Bank ("FHLB") stock. Interest income on loans constituted approximately 97% of the

Bank's gross income. The majority of this interest was interest income on mortgages.

Customers of the Bank have access to banking services on the Internet. Some of the Internet services include online bill paying, the ability to open accounts, and the ability to make account transfer requests.

The Bank had 13 employees who worked in Delaware, either in full or in part, at year-end 2000, 12 at year-end 2001, 12 at year-end 2002, and 11 at year-end 2003. The employees in Delaware had the following job titles during the calendar periods of 2000-2003: Accounts Payable Clerk, Receptionist, Human Resources Administrator, Marketing Manager, Accountant, Project Coordinator, Servicing Manager, Assistant Controller, Analyst—Jr., MIS Specialist, Senior Trust Officer, Asset Manager Supervisor, Branch Manager, Senior Vice-President, and Teller.

On the Bank's originally filed 2000 through 2002 Delaware Bank Franchise Tax returns, the Bank sourced 50% of its income to Delaware. In 2003, after Delaware commenced its audit, the Bank prepared its 2003 Delaware Bank Franchise Tax return (filed in January 2004) based on its own separate accounting analysis. The Bank believed that it was entitled to a reduction of its taxable income because the preponderance of its income producing and headquarters activities occurred in jurisdictions other than Delaware.

EXHIBIT 1
Consolidated Income Before Taxes for Lehman Brothers Bank, FSB

For the Year-ended December 31	2000	2001	2002	2003
	(In Thousands)			
Income Before Taxes for Lehman Brothers Bank, FSB and Subsidiaries per Audited Consolidated Financial Statements; Prepared Based on Regulatory Accounting Standards	111,395	193,515	406,465	666,304
Post-Close Adjustments	22,798	18,816	(42,729)	11,650
Other	1,700	(580)	120	0
Subsidiary (income)/loss:				
Financial Freedom	0	0	0	(6,462)
Sotheby's	0	0	0	(23)
Consolidated Income Before Taxes for Lehman Brothers Banks, FSB	135,893	211,751	363,796	671,469

The Bank believed that it was entitled to at least a fifty percent reduction on its originally filed 2000 through 2003 Delaware Bank Franchise Tax returns because the vast majority of its income was being taxed in New York State and other jurisdictions. *[See Exhibit 2 Attached].* Even though a major portion of the Bank's income was taxed in New York and other jurisdictions, the Bank took a conservative approach and only reduced its taxable income by fifty percent in tax years 2000-2002. In 2003, Delaware challenged the Bank's filing methodology. The Delaware Banking Commissioner's office asserted that 100% of the Bank's income was subject to the Delaware Bank Franchise tax.

In response to Delaware's challenge, the Bank re-examined its filing methodology in Delaware. As a part of this process, the Bank engaged E&Y to prepare amended Delaware Bank Franchise Tax returns computing the Delaware facility's income and expense on a separate accounting basis (subsequently detailed in the E&Y Factual Support Memorandum). The Bank amended its 2000-2003 Delaware Bank Franchise Tax returns utilizing the methodology outlined in E&Y's Factual Support Memorandum. As mentioned previously, the vast majority of the Bank's income is generated from activities conducted in New York and jurisdictions other than Delaware. New York is the Bank's commercial domicile and is the situs of its executive offices. Sourcing 100% of the Bank's income to Delaware is distortive and would result in the double taxation of its income.

Procedures

The following procedures were undertaken by PricewaterhouseCoopers to confirm the accuracy and reasonableness of E&Y's Factual Support Memorandum:

- Participated in several meetings and conference calls with Lehman Brothers Inc.'s tax group, key Bank employees, and E&Y to gain an understanding of the Bank's operations and to determine that Bank activities, and the corresponding income and expense associated with these activities, are properly attributable to Delaware.

- Interviewed several key Bank employees including: David Essex, Chief Financial Officer; Karen Dawson, Branch Manager; Gale Stawicki, Senior Vice President/ Director of Retail Banking; Kathryn Palmer, Assistant Controller; Jennifer Helms, Accountant; Dinah Ashley, Accounts Payable Clerk; Michael Mood, Accountant; and Kavita Shah, Senior Associate. These interviews were conducted to gain an understanding of the individual roles and responsibilities of these employees. Further, these interviews were conducted to gain a better understanding of the Delaware facility's day-to-day operations and ascertain that the activities, and the corresponding income and expenses associated with these activities, are properly attributable to

Delaware. During the interview process, PricewaterhouseCoopers spent several days at the Delaware facility and observed its operations.

- Analyzed the accuracy of each line item of income and expense on E&Y's separate accounting profit and loss statement (part of E&Y's Factual Support Memorandum). The analysis involved tracing income and expense for the Delaware facility to the Bank's general ledger system.

Observations

Meetings with key Bank employees confirmed that the following activities took place in Delaware during the 2000 through 2003 audit period, as per E&Y's Factual Support Memorandum:

- Call center activity related to the Bank's retail business that was previously outsourced to Teletek was moved in-house and performed in Delaware starting in June, 2003. All mortgage related questions are referred to Aurora Loan Services, Inc. ("Aurora") located in Denver, Colorado.

- The coding for the majority of the Bank's check requisitions, other than items related to occupancy or payroll, is performed in Delaware and sent to New York for processing. In some cases where the vendor is located in Delaware, the

Delaware personnel may code and process the check requisition. The check requisitions for the Sotheby's joint venture are prepared and processed in Delaware, and the Bank receives $2,000 per month from Sotheby's for this service.

- The Bank operates its Trust business in Delaware and New York. The Bank applied for and was approved for trust powers by the Office of Thrift Supervision ("OTS") in 2001. The Bank applied for and received an agency license to operate its Trust business in New York in mid 2002 and commenced its Trust operations in June 2002. The Bank managed two accounts in 2002, its initial year, and ten accounts by the end of 2003. The official situs of the Trust is 1000 West Street, Wilmington, Delaware 19801, the physical location of the Delaware branch.

- All Delaware-based Community Reinvestment Activity is performed in Delaware.

- All cash accounting and cash settlements for the Bank's FHLB and Federal Reserve accounts are performed in Delaware. The FHLB account generates monthly interest of $2,000. No interest is paid on the Federal Reserve account.

- All requests for wire transfers for Financial Freedom customers (approximately 100 per day) are processed in Delaware.[1] Additionally, all ATM related services and individual bank statement processing are handled in Delaware.

- Maintenance of the Sanchez (e.g., general ledger) system was performed in Delaware until 2002, when this technology function was transferred to New York.

- The collection functions for loans originated in Delaware were performed in Delaware until these collection functions were transferred to Aurora in April 2000.

- Appropriate Delaware personnel prepare and file the OTS regulatory reports on a quarterly basis. The Delaware facility is not compensated for this service.

- Local retail banking services are handled in Delaware. However, the Bank converted to a web-based initiative in July 2000. During the 2000-2003 audit

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[1] On August 1, 2001, Lehman Brothers Holdings Inc. contributed its 72.5% ownership interest in Financial Freedom Holdings Inc. to the Bank. Financial Freedom Holdings, Inc. is a Delaware Corporation that through its wholly owned subsidiary Financial Freedom Senior Funding Inc., originates reverse mortgage loans.

period there were 75 to 100 internet bank customers.

Findings

The review of E&Y's Factual Support Memorandum yielded the following findings:

- *Delaware Revenue*: E&Y's separate accounting profit and loss statement properly attributed the revenue items described above to Delaware. PricewaterhouseCoopers was able to verify the accuracy of each item of income on the separate accounting profit and loss statement by matching each line item to the Bank's general ledger. Furthermore, each component of interest income and other revenue attributed to Delaware was discussed in detail with the appropriate Bank personnel. In situations in which it was not clear whether an activity took place in Delaware, or a reasonable allocation methodology was not apparent, 100% of the revenue was attributed to Delaware (e.g., FHLB stock dividends). This is a reasonable, conservative approach from a separate accounting perspective.

- *Delaware Expenses*: E&Y's separate accounting profit and loss statement properly attributed the expense items described above to Delaware. Billing detail for every directly incurred expense, including legal fees and settlements,

communication, advertising, amongst others, was reviewed and matched to the general ledger. The allocation methodology for those expenses such as occupancy that were not directly incurred by the Delaware facility, but were allocated to the Delaware facility, were confirmed for reasonableness and compared to the general ledger.

- *Non-Delaware Revenue*: E&Y did not attribute revenue or expense to Delaware for activities that clearly took place outside of Delaware. As mentioned previously, approximately 97% of the Bank's gross income is interest income. Substantially all of this interest income is interest income earned on mortgages. All of the income producing activities associated with this mortgage business, including mortgages originated by the Bank and mortgage pools purchased by the Bank, take place outside of Delaware. All major decisions regarding the mortgage business take place outside of Delaware, where the Chief Credit Officer is located. In addition, a credit committee located outside of Delaware generally is responsible for approving and authorizing the purchase of certain mortgage pools. All mortgage administration activities take place outside of Delaware and are generally performed in Colorado and Nebraska. Due to the fact that the entire mortgage business is run outside of Delaware, E&Y correctly attributed

none of the interest income from the mortgage business to Delaware except for those legacy mortgages originated by the predecessor bank, Delaware Savings Bank, F.S.B.

/s/ Jack R. Kramer - 9/28/04

Jack R. Kramer Date

Partner

PRICEWATERHOUSECOOPERS [LOGO]

EXHIBIT 1

Jack R. Kramer
Partner, State and Local Tax

Jack is a state and local tax ("SALT") partner located in the New York office of PricewaterhouseCoopers LLP. Jack has over 15 years' experience advising clients on state and local tax matters in a wide variety of areas, including income/franchise tax, gross receipts tax, and sales/use tax. Jack specializes in advising clients in service industries on proper apportionment methodologies and receipts factor sourcing issues.

Jack is the national partner in charge of PricewaterhouseCoopers LLP's Cost of Performance ("COP") service offering. Jack and his team have developed a comprehensive approach to help facilitate the appropriate sourcing of revenue to jurisdictions for each income-producing activity, based on costs of performance. The COP service offering utilizes research matrices and modelling software to enable taxpayers in various industries to ascertain the appropriate jurisdiction to which to attribute receipts from services rendered.

Jack received his LL.M. in Taxation from New York University School of Law and his J.D./M.B.A. from Syracuse University. He has a B.S. in Finance, with a concentration in Accounting, from Fairfield University. Jack has instructed courses on state and local

tax at Fordham University Graduate School of Business. He is admitted to practice law in New York and Connecticut. He is a frequent speaker on state and local tax issues at industry forums and has recently published an article addressing the state tax treatment of LLCs for the Bureau of National Affairs.

EXHIBIT 2

Lehman Brothers Bank, FSB
Schedule of Tax Liability

Ref#	States	Tax Years			
		2000	2001	2002	2003**
1	California*	3,638,546	2,697,004	3,916,657	6,301,284
2	Colorado*	6,802	–	621,964	1,205,380
3	Delaware***	2,355,000	3,209,860	4,570,872	2,541,158
4	Florida	47,848	–	382	–
5	Kansas*	–	–	–	–
6	Louisiana	10	10	53,249	57,936
7	Maine*	–	–	–	–
8	Maryland	344,768	99,627	486	500
9	Minnesota*	–	–	–	21,174
10	Nebraska*	–	–	–	–
11	New Hampshire*	–	–	–	–
12	New York State****	8,012,802	7,195,628	10,090,349	18,690,000
13	New York City****	7,193,832	6,777,166	9,451,295	19,794,292
14	Oregon*	848	10	25,191	121,131
15	Pennsylvania	–	–	–	–
16	Tennessee	100	100	100	100
17	Utah*	–	–	–	–
	Total	21,600,556	19,979,405	28,730,545	48,732,955

* States filing a Unitary Return.

** 2003 separate and unitary income tax returns are currently on extension, with the exception of Delaware. Therefore, the amounts represent estimated tax liabilities for the 2003 tax year, except for Delaware.

*** Delaware tax liability represents the tax liability as reflected on the originally filed Delaware tax returns. For 2003, taxpayer paid $6,800,000 in Delaware estimated tax payments. As a result, the original 2003 return reflected a refund due the taxpayer of $4,258,842 which was never issued ($2,541,158 less $6,800,000).

**** NYS & NYC tax liability includes mandatory installment payment for succeeding tax year.

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(2)

No. 07-1010

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IN THE

Supreme Court of the United States

LEHMAN BROTHERS BANK, FSB,
Petitioner,

v.

STATE BANK COMMISSIONER,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Delaware

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BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

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LEHMAN BROTHERS BANK, FSB,
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On Petition for a Writ of Certiorari to the Supreme Court of Delaware

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*

This brief *amicus curiae* in support of Petitioner (Lehman Brothers Bank, FSB) is filed on behalf of the Council On State Taxation ("COST").[1] COST is a

[1] The parties have consented to the filing of this brief. Counsel of record for all parties received notice at least 10 days prior to the due date of the *amicus curiae*'s intention to file this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae*, its members, or its counsel made a monetary contribution to its preparation or submission.

non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States; companies from every industry doing business in every state.

COST's members are concerned that the risk of multiple taxation will become a reality if this Court allows Delaware's unapportioned tax to stand. A state tax left standing by this Court serves as a convenient recipe for other states seeking new revenue sources, because "[i]f [one state] is free to exact . . . a tax, other states to which the commerce extends may, with equal right, lay a tax similarly measured." *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 439 (1939). *See also McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 48 (1940). That is precisely why "[t]he jurisdiction of [one state] to tax 'must be determined on a basis which is consistent with the like jurisdiction of other States.'" *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292, 326 (1944) (Stone, C.J., dissenting) (quoting *Johnson Oil Ref. Co. v. Oklahoma*, 290 U.S. 158, 162 (1933)). If the Court leaves the decision of the Delaware Supreme Court standing without guidance, other states will undoubtedly adopt similarly unsound theories of taxation, exacerbating multiple taxation of income.

STATEMENT OF THE CASE

This case raises the issue of whether a state can tax all of the income of an interstate entity based simply on the determined fact that the entity has a domicile in the state for regulatory purposes. The Delaware Supreme Court held that Delaware could tax all the income of a bank engaged in interstate

business based on the sole fact that the bank was domiciled in Delaware. The commercial domicile of Lehman Brothers Bank ("Bank") was disputed in the lower court. The Delaware Bank Commissioner argued that the Bank was commercially domiciled in Delaware based on the Bank's listing of Delaware as its home state on its federal stock charter. The Bank argued it was domiciled in New York, the state where the Bank's operations are managed. In affirming that the Bank is domiciled in Delaware without any branches or subsidiaries in other states, the Delaware Supreme Court held that Delaware could tax 100% of the Bank's income. The ruling contradicts the standards from this Court that the Commerce Clause and the Due Process Clause mandate state taxes be fairly apportioned to only tax those activities conducted within the taxing state.

SUMMARY OF ARGUMENT

The Delaware Supreme Court has incorrectly interpreted *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) to sustain Delaware's tax on the Bank. Delaware's taxing scheme on a Delaware-domiciled bank with income clearly subject to taxation in other states violates the mandates of the Due Process Clause and the Commerce Clause. A state simply cannot tax 100% of income that is generated in interstate operations taxable in multiple states. The impact of an unapportioned income tax on multistate business is intensified in an era when states increasingly assert that businesses must pay tax to a state simply because they have a limited economic presence in the state.

ARGUMENT

Petitioner lays out compelling legal reasons for granting *certiorari* in this case: The Delaware Court's unwise departure from this Court's precedent in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), *Central Greyhound*, 334 U.S. 653 (1948), and *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931); and the conflict among states as evidenced in decisions like *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108 (Pa. 2003).

Amicus will not repeat all of these points. Instead, it will focus on additional legal and policy considerations that add gravitas to this matter.

I. THIS COURT SHOULD GRANT REVIEW IN ORDER TO PRESERVE FUNDAMENTAL COMMERCE CLAUSE APPORTIONMENT REQUIREMENTS THIS COURT HAS LONG RECOGNIZED

The Delaware Supreme Court wrongly states that under this Court's decisions, multiple taxation on the same income is permissible when a "structural apportionment framework" results in the imposition of tax on 100% of the income of an entity when only 2% of the entity's activity occurred within Delaware. Implicit within the Delaware court's holding is the recognition that the "structural apportionment framework" refuses any bank with a Delaware "home office" or "principal place of business" the right to apportion income among the jurisdictions in which it does business. This Court has long considered a state's unwillingness to allow the apportionment of income or other tax bases where the business domicile is within the state to be violative of the Com-

merce Clause. In the words of Chief Justice Stone in the context of intangibles, "[w]hile the existence of a business domicile has been thought to afford a basis for the state taxation of intangibles, on the theory that they have become localized there. . . . the taxation of intangibles of interstate [companies] is subject to the rule of apportionment wherever the tax without [apportionment] would subject the commerce to the burden of multiple state taxation." *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292, 318 (1944) (Stone, C.J., dissenting) (*citing Southern Ry. v. Kentucky*, 274 U.S. 76, 81 (1927); *Wallace v. Hines*, 253 U.S. 66, 69-70 (1920); *Meyer v. Wells, Fargo & Co.*, 223 U.S. 298, 300 (1912); *Fargo v. Hart*, 193 U.S. 490, 499 (1904); *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 223-25 (1897)).

In the landmark case *Pullmans Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891), this Court rejected the Middle Ages rule for personal property expressed in the maxim *mobilia sequuntur personam* (movables follow the person) and the proposition that personal property was only subject to taxation at the owner's domicile. The Court reasoned "[t]he result of holding otherwise would be that, if all the states should concur in abandoning the legal fiction that personal property has its *situs* at the owner's domicile, and in adopting the system of taxing it at the place at which it is used and by whose laws it is protected, property employed in any business requiring continuous and constant movement from one state to another would escape taxation altogether." *Id.* at 24. *See also Union Refrigerator Transit v. Kentucky*, 199 U.S. 194 (1905) (holding the mere fact that a company was incorporated in Kentucky did not allow Kentucky to tax personal property located in other states).

The powerlessness of a domicile state to assert its full taxing power over a domiciled company was also addressed by the Court in *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952). In that case, the Court held that Ohio could not tax 100% of the taxpayer's vessels where it was shown that the vessels were subject to apportionment. *Id.* at 384. Based on the Court's prior holding in *Ott v. Mississippi Val. Barge Line*, 336 U.S. 169 (1949), where the Court held that vessels in inland waters could be apportioned, the Court in *Standard Oil* rejected Ohio's premise that it could fully tax the taxpayer's vessels based on the taxpayer's domicile in that state and held such tax on property not located in Ohio was unconstitutional.

The Court noted, "[t]he rule which permits taxation by two or more states on an apportionment basis precludes taxation of all the property by the state of domicile . . . Otherwise there would be multiple taxation of interstate operations and the tax would give no relation to the opportunities, benefits, or protection which the taxing state gives those operations." *Standard Oil Co.*, 342 U.S. at 385-386. Importantly, the Court in *Standard Oil* distinguished a prior case, *Northwest Airlines, Inc. v. State of Minnesota*, 322 U.S. 292 (1943), on grounds that in *Northwest Airlines* the taxpayer had not shown its property acquired a taxable situs in another state.[2]

This Court in *Northwest Airlines* upheld, under a version of the "home port" doctrine, an unapportioned

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[2] While it can be argued that *Standard Oil* dealt with an ad valorem tax and not an income tax, the conclusion does not differ for income taxes. The Court in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 at 443-444 (1980) rejected the taxpayer's notion that only the taxpayer's domicile state, New York, could tax the taxpayer's dividends.

Minnesota tax on the entire fleet of airplanes used by a Minnesota domiciliary in interstate commerce. Subsequently, this Court substantially eroded the rationale of that decision in *Braniff Airways, Inc. v. Nebraska Bd. of Equalization*, 347 U.S. 590 (1954), which held that a non-domiciliary state could impose an apportioned tax on the value of an interstate air carrier's flight equipment. The "home port" doctrine, at least for moving equipment other than oceangoing vessels, "has yielded to a rule of fair apportionment among the States." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 343, 442 (1979). Indeed, the Court has treated Chief Justice Stone's dissenting opinion in *Northwest Airlines* and its mandate for apportionment as an accurate statement of current Commerce Clause doctrine. *Id.* at 443, 452 n.17, 455.

By refusing to allow the Bank to apportion its income, the Delaware court ignored the logic of the *Northwest Airlines* dissent. The Bank has operations in other states and is afforded with opportunities, benefits, and protection from other states. Because the Bank is subject to apportioned taxation in other states, the *Northwest Airlines* dissent teaches that the domicile state is precluded from taxing all of the Bank's income. As this Court held in *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458 (2000), holding California's disallowance of interest expense to a nondomiciliary corporate taxpayer violated both the Due Process Clause and the Commerce Clause, Delaware's law at issue in this case "constitutes impermissible taxation of income outside its jurisdictional reach." *Id.* at 468. Not allowing a taxpayer to apportion its income also represents a clear "attempt to tax property beyond the jurisdiction of the state, and to throw an uncon-

stitutional burden on commerce among the states." *Fargo v. Hart*, 193 U.S. 490, 502 (1904).

As the Court articulated in *Moorman Industries*, "States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportion to the business transacted . . . in that State." *Moorman Mfg. Co. v. Bair* 437 U.S. 267, 274 (1978) (citing *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931) (quotations omitted)). However, in this case the appropriateness of an apportionment formula is not at issue because there is simply no apportionment method available to the Bank. Delaware taxes 100% of the Bank's income based solely on the Delaware Bank Commissioner's finding that the Bank was domiciled in Delaware and the Commissioner's determination that the Bank had no out-of-state branches or subsidiaries. As a result, the Bank is impermissibly subject to tax by Delaware in a manner that is completely out of proportion with the business it transacted in Delaware. The Bank was not conducting business only in Delaware; in fact, it was conducting the vast majority of its business in other states.

As the Petitioner thoroughly argues, the Delaware court's holding also runs contrary to *Goldberg v. Sweet*, 488 U.S. 252 (1989), where this Court held "the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction." The Bank is engaged in an interstate banking business. It transacts a significant amount of business outside of Delaware. The Delaware court's holding that it can tax 100% of the Bank's

income reaches far "beyond that portion of value that is fairly attributable to economic activity with the taxing State." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).[3] To be sure, the potential for duplicative taxation is not speculative.

While this Court has sustained the states' ability to apportion income of an interstate business, the Court has also struck down the rigid use of apportionment formulas that lead to distortive results. For example, the Court did not allow Missouri to rigidly use its millage apportionment on rolling stock when it led to a distortive result (attempting to tax 8.24% of the rolling stock when the taxpayer demonstrated only 2.71% was in Missouri), *Norfolk and W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968). Delaware's statutory formula leads to the same "unconscionable and unconstitutional result." *Id.* at 321. This Court should grant *certiorari* to squarely address this issue of apportionment and hold that Delaware's unapportioned tax on the Bank violates the fair apportionment requirement of *Complete Auto*.[4]

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[3] To justify its tax regime, the Delaware Supreme Court substantially relies on a decision by the Supreme Court of Rhode Island, *Commercial Credit Consumer Services v. Norberg*, 518 A.2d 1336 (R.I. 1986), which was decided before this Court ruled in *Jefferson Lines*. In *Norberg*, the Rhode Island court erroneously concludes that Rhode Island's tax law did not subject a corporation to multiple taxation on the same income. While Rhode Island allowed a corporation to deduct taxes paid to another state, it still taxed the same income because it did not exclude that income from taxation.

[4] Delaware is not the only state that refuses to allow apportionment. *See e.g.* W. Va. Code § 11-24-7 (specifying that financial organizations that are commercially domiciled in West Virginia must apportion 100% of income to West Virginia).

II. THE IMPACT OF THE DELAWARE COURT'S FLAWED DECISION IS AMPLIFIED BY A TREND AMONG STATES TO ASSERT THAT COMPANIES ARE TAXABLE IN THEIR STATE BASED SOLELY UPON AN ECONOMIC PRESENCE

The impact of an unapportioned income tax on multistate business is intensified in an era when states increasingly assert that businesses must pay tax to a state simply because they have a limited economic presence in the state. When multiple states are allowed to impose unapportioned taxes on the same income by asserting an economic nexus theory, duplicative tax will certainly occur.

In *Quill Corp. v North Dakota,* 504 U.S. 298 (1992), this Court reiterated what constitutes "substantial nexus" for purposes of Commerce Clause analysis; citing from the Court's prior holding in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), it requires a physical presence in the taxing state. The Court also expressed its desire for "a rule [that] firmly establishes the boundaries of legitimate state authority to impose . . . taxes. . . *Quill* at 315.

In this case, the Bank has the requisite "substantial nexus" under *Quill* to be subject to tax in more than one state. Apart from Delaware where it had 11 to 13 employees, the Bank had an office with 20 to 25 full-time employees in New York and an additional 90 dual employees located in New York and Colorado that also worked for other affiliates of the Bank. App. To Pet. Cert. 148a. The Bank also had an affiliate conducting extensive mortgage activity in California.

Thus, it is not disputed that the Bank has the requisite physical presence to be subject to taxation in not only Delaware, but also New York and other states. The record demonstrates that over $106 million in state and local income taxes were paid for the four years at issue in this case. Petr.'s Br. 12.

Most troubling to the *amicus*, however, is the impact of Delaware's position in states where the Bank does not have physical presence. State courts and legislatures continue to scribe exceptions to the physical presence nexus requirement espoused in *Quill*. Rather than relying on the *Quill* physical presence standard, states are asserting that non-sales and use taxes (e.g., income and gross receipts taxes) can be imposed on taxpayers using the lower threshold of economic presence. While we find serious fault and consternation with the legality of an economic presence standard—which has never been upheld by this Court—the suspect standard has been considered to pass constitutional muster by the highest courts in New Jersey, South Carolina, and West Virginia.[5] The use of this low nexus threshold

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[5] *See Lanco, Inc. v. Director*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2997 (2007); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004), *cert. denied*, 546 U.S. 821 (2005); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Tax Comm'r of West Virginia v. MBNA America Bank NA.*, 640 S.E.2d. 226 (W.V. 2006), *cert. denied sub nom.*, *FIA Card Services NA v. Tax Comm'r of West Virginia*, 127 S. Ct. 2997 (2007). Lower state courts have also upheld an economic nexus standard. *See Bridges v. Geoffrey, Inc.*, No. 2007 CA 1063, 2008 WL 399205 (La. Ct. App. Feb 8, 2008); *Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005).

in order to impose taxes on out-of-state businesses only intensifies the Bank's and other taxpayers' exposure to taxation in a multitude of states; fueling the need for this Court to affirm that states must fairly apportion their taxes imposed on interstate activities.

CONCLUSION

In conclusion, this Court should extirpate any concept that a state, based on a conclusion that a business is commercially domiciled in the state, can tax 100 percent of the income earned by the business when such income is clearly subject to taxation in other states on an apportioned basis. *Amicus* respectfully requests the Court to review the Delaware Supreme Court's decision because it contravenes both the Due Process Clause and Commerce Clause by not affording the Bank with any meaningful apportionment of its income to reflect its activities conducted outside of Delaware.

Respectfully submitted,

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IN THE

Supreme Court of the United States

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Petitioner,

v.

STATE BANK COMMISSIONER,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Delaware

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BRIEF OF *AMICUS CURIAE* U.S. BANCORP IN SUPPORT OF PETITIONER

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BRIEF OF *AMICUS CURIAE* U.S. BANCORP IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

This brief *amicus curiae* in support of Petitioner is filed on behalf of U.S. Bancorp ("Bancorp").[1] Bancorp is a publicly held multi-state financial holding company with operations in all fifty States and several foreign jurisdictions. U.S. Bank Trust National Asso-

[1] The parties have consented to the filing of this brief. Counsel of record for all parties received notice at least ten days prior to the due date of the *amicus curiae*'s intention to file this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae* made a monetary contribution to the brief's preparation or submission.

ciation ("Trust") is a wholly-owned subsidiary bank of Bancorp's lead bank, U.S. Bank National Association, which has operations in New York and Delaware. Trust is the resulting company from a merger of two separate trust banks in 2002—one that was headquartered in New York, and one that was headquartered in Delaware—to streamline operations and reduce the number of legal entities owned by Bancorp.

As of December 31, 2007, Trust employed five persons in Delaware, and sixty people in New York. The company is domiciled in Delaware, but nearly all of its employees and most of its activity are in the New York trust office. After the merger of the two companies, Trust filed the requisite tax returns in both Delaware and New York, apportioning the income of the company to the two States according to their respective apportionment statutes.

The Delaware Banking Commissioner took issue with the apportionment of the income and issued deficiency notices to Trust, indicating that it was not eligible to apportion its income outside of Delaware because it did not have either a "branch" or a "subsidiary" conducting its out-of-state activity.

Trust pays the Delaware bank franchise tax at issue in this case. Like petitioner, Trust's business operations do not require, and Trust does not operate, its national banking business through federally approved branches or through subsidiaries. The decision of the Delaware Supreme Court upholding as constitutional the unapportioned tax on a taxpayer doing business in multiple States results in Trust paying tax on one hundred percent of its nationwide income to Delaware. This result occurs solely because Trust does not operate through branches or sub-

sidiaries, which Delaware arbitrarily requires as condition of a taxpayer's right to apportion its income.[2] The Delaware statute denies this right to Trust regardless of the extent of its out-of-state activities and despite the fact that Trust, as a bank limited to trust powers, is not even permitted to operate through branches.

SUMMARY OF ARGUMENT

This case raises the fundamental question of whether a State may tax one hundred percent of the income of a corporation whose income is also subject to tax in other States in which it conducts its interstate business. Settled Commerce Clause doctrine provides a negative answer to this question, for to hold otherwise would expose a taxpayer to the type of multiple taxation that the Commerce Clause forbids. *Amicus* recognizes that this Court has granted great flexibility to States in fashioning their own methods of apportionment as long as those methods are "'fairly calculated' to assign to [a State] that portion of net income 'reasonably attributable' to the business done [in that State]," *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 273 (1978). Such flexibility, however, does not encompass the right to deny apportionment altogether when other States have the right to tax a portion of the taxpayer's income.

The constitutional flaw in the Delaware statute is not a defect unique to that State. New Jersey, West Virginia, and Georgia each employ tax regimes

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[2] U.S. Bancorp adopts, for purposes of its brief in support of the Petition, the definitions of "branch" and "subsidiary" utilized by the Delaware Supreme Court below.

that expose taxpayers to a similar risk of multiple taxation and reinforce the need for this Court's review of the case.

ARGUMENT

I. THE DECISION BELOW RUNS ROUGHSHOD OVER BEDROCK COMMERCE CLAUSE DOCTRINE.

A. The Commerce Clause Bars A Domiciliary State From Taxing On An Unapportioned Basis Values That Other States Have Power To Tax On An Apportioned Basis.

The court below concluded that Delaware may tax the unapportioned income that a Delaware domiciliary bank derived from its interstate mortgage banking business, despite undisputed evidence that the bank had more than one hundred out-of-state employees through which it conducted a substantial portion of its mortgage banking activity. Pet. App. at 7. This ruling flies in the face of the fundamental Commerce Clause principle that no State may tax on an unapportioned basis values which other States may tax on an apportioned basis.

This Court's Commerce Clause doctrine has long protected taxpayers from the risk of improper multiple taxation. *See, e.g, J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938) (condemning tax that subjects "[i]nterstate commerce . . . to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids"). Accordingly, a taxpayer that can demonstrate that it is taxable in another State has a right to divide its tax base. Thus, a taxpayer located in State A that shows it is taxable in State B has a constitutional

right to insist that State A recognize its right to divide its tax base between the States, attributing at least a portion of the overall tax base—whether it be property, income, or receipts—to State B. The logical underpinning for this rule is irrefutable: If a taxpayer is taxable in more than one State, denial by either State of the right to division of the tax base would expose the taxpayer to an unconstitutional risk of multiple taxation.

This Court articulated the underlying principle in *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952). The taxpayer, an Ohio-based corporation, owned boats and barges that it employed for the transportation of oil along the Mississippi and Ohio Rivers. The vessels, though registered in Cincinnati, made only occasional stops in Ohio for repairs. Their main terminals were in other States. Ohio assessed an ad valorem personal property tax on the unapportioned value of the vessels. This Court had recently sustained the power of a nondomiciliary State to tax an apportioned share of the value of vessels that operated within the State in *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169 (1949). Ohio contended that *Ott* did not deprive the domiciliary State of the power to tax the entire value of the vessels, a power the domiciliary State possessed under the Court's earlier doctrine. This Court flatly rejected Ohio's contention. Observing that earlier cases sustaining the power of the domiciliary State to tax the full value of personal property were predicated on the fact that the property had not acquired a taxable situs elsewhere, this Court declared that these cases

> have no application here since most, if not all, of the barges and boats which Ohio has taxed were almost continuously outside Ohio during

> the taxable year. . . . [M]ost, if not all, of them were operating in other waters and therefore under *Ott v. Mississippi Barge Line Co.* . . . could be taxed by the several states on an apportionment basis. *The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile* . . . . Otherwise there would be multiple taxation of interstate operations and the tax would have no relation to the opportunities, benefits, or protection which the taxing state gives those operations.

Standard Oil, 342 U.S. at 384-85 (emphasis supplied).

This Court has steadfastly adhered to the view that the power of one State to tax an interstate enterprise's property or income on an unapportioned basis cannot be sustained when other States have the power to tax such property or income on an apportioned basis. Thus, in *Central Railroad Co. v. Pennsylvania*, 370 U.S. 607 (1962), this Court, while sustaining the power of the State to impose a tax on the unapportioned value of the taxpayer's rolling stock because it had failed to establish that it was subject to an apportioned tax elsewhere, nevertheless observed that "multiple taxation of interstate operations . . . offends the Commerce Clause," *id.* at 612, and "multiple taxation is possible . . . if there exists some jurisdiction, in addition to the domicile of the taxpayer, which may constitutionally impose an ad valorem tax." *Id.* Likewise, in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), this Court, in delineating the constitutional restraints on State taxation of the instrumentalities of commerce under the Commerce Clause, unequivocally declared that "[t]he corollary of the apportionment principle,

of course, is that no jurisdiction may tax the instrumentality in full." *Id.* at 447.

In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), this Court reaffirmed the rule precluding one State from taxing the unapportioned share of a tax base that is taxable by apportionment in other States in the context of State taxation of income. *Mobil* presented the question whether Vermont could tax an apportioned share of dividends that Mobil Oil Corporation, a New York domiciliary, received from its foreign subsidiaries. Mobil had challenged the inclusion of such dividends in its apportionable tax base under the Commerce Clause, contending, among other things, that there was a risk of multiple taxation on the ground that New York, the State of its commercial domicile, had the power to tax one hundred percent of its dividends, and that Vermont's assertion of the right to tax an apportioned share of such dividends therefore exposed it to multiple taxation. Vermont countered that there was no violation of the multiple taxation principle because the New York statute did not in fact tax such dividends.

This Court rejected the underlying argument that only New York could tax the income. After reiterating the fundamental principle that "[t]axation by apportionment and taxation by allocation to a single situs are theoretically incommensurate," *id.* at 444, this Court declared:

> The reasons for allocation to a single situs that often apply in the case of property taxation carry little force in the present context. Mobil no doubt enjoys privileges and protections conferred by New York law with respect to ownership of stock holdings, and its activities in that State no doubt

> supply some nexus for jurisdiction to tax. . . . Although we do not presume to pass on the constitutionality of a hypothetical New York tax, we may assume, for the present purposes, that the State of commercial domicile has the power to lay *some* tax on the appellant's dividend income. *But there is no reason in theory why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. These are the circumstances in which apportionment is ordinarily the accepted method.*

Id. at 445-46 (emphasis supplied).

In short, the Commerce Clause precludes one State from denying a taxpayer the right to a division of the tax base when a portion of that tax base is taxable by other States. By allowing Delaware to tax one hundred percent of the taxpayer's income the Delaware Supreme Court violated this Commerce Clause principle. This Court's intervention is necessary to correct the plain error of the ruling below, which can only cause additional mischief if left undisturbed.

B. The Court Below Erred In Holding That The Taxpayer Must Demonstrate Actual Multiple Taxation Rather Than The Risk Of Multiple Taxation To Establish A Commerce Clause Violation.

In holding that Delaware's unapportioned tax survived scrutiny under the Commerce Clause, the court below relied in part on the fact that the "the Bank failed to prove 'by clear and cogent evidence' precisely

what income (if any) was taxed by other states," *Lehman Bros. Bank, FSB v. State Bank Comm'r*, 937 A.2d 95, 113 (Del. 2007) , and "nothing in the record establishes actual multiple taxation or a significant threat thereof."[3] The court committed plain error in suggesting that anything other than the risk of multiple taxation is the relevant constitutional inquiry for the right to apportionment.

In delineating the Commerce Clause doctrine forbidding multiple taxation, this Court has made it clear that it is the mere *risk*—not the actuality or significant threat—of multiple taxation that gives rise to the Commerce Clause claim. Thus, in *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939), this Court stated:

> Here the tax, measured by the entire volume of the interstate commerce in which appellant participates, is not apportioned to its activities within the state. If Washington is free to exact such a tax, other states to which the commerce extends may, with equal right, lay a tax similarly measured for the privilege of conducting within their respective territorial limits the activities there which contribute to the service. The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, *"the risk of a multiple burden to which local commerce is not exposed."*

Id. at 439 (quoting *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938) (emphasis supplied).

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[3] While the Delaware Supreme Court referred to a "significant threat" standard, its focus was entirely on whether there was proof of actual multiple taxation.

More recent decisions have put the matter to rest by reaffirming that the risk, and not the actuality or significant threat, of multiple taxation suffices to establish a constitutional violation. In holding squarely that the Commerce Clause protects taxpayers against the risk of multiple taxation, this Court in *Mobil* declared:

> Inasmuch as New York does not presently tax the dividends in question, actual multiple taxation is not demonstrated on this record. The Vermont courts placed some reliance on this fact, and much of the debate in this Court has aired the question whether an actual burden need be shown. *We agree with Mobil that the constitutionality of a Vermont tax should not depend on the vagaries of New York tax policy.*

Mobil Oil, 445 U.S. at 444 (emphasis supplied). *See also Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 228-29 (1980) (reaffirming "risk" rule of multiple taxation).

The Delaware Supreme Court's misguided reliance on proof of actual multiple taxation as an essential predicate of a Commerce Clause violation compounds its error of denying apportionment despite the unquestioned authority of other States to tax a portion of petitioner's income, and reinforces the need for this Court's review.

II. THE CONSTITUTIONAL PROBLEM WITH THE DELAWARE STATUTE EXISTS IN OTHER STATES.

The constitutional problem raised by the Delaware statute is presented by similar statutes in other

States, reinforcing the need for this Court's intervention to correct the plain error of the decision below.[4]

A. New Jersey Imposes A "Regular Place Of Business" Requirement As A Condition of the Right to Apportion

Under a regime analogous to Delaware's "subsidiary or branch" rule, New Jersey imposes a "regular place of business" requirement before a corporation may apportion its income. A New Jersey corporation with taxable income producing activities in other States is subject to tax on one hundred percent of its income unless the corporation has a "regular place of business" in another State. N.J. Stat. Ann. § 54:10A-6. New Jersey defines "regular place of business" to include *only* "any bona fide office . . . , factory, warehouse, or other space of the taxpayer which is *regularly maintained*, occupied and used by the taxpayer in carrying on its business *and in which one or more regular employees are in attendance.*" N.J. Admin. Code 18:7-7.2 (emphasis supplied). Like Delaware's "branch or subsidiary" rule, New Jersey's definition of "regular place of business" is narrower than the range of taxable activities in which a taxpayer could engage in generating income in other States, thereby exposing the taxpayer to the risk of multiple taxation.

Under the New Jersey framework, common business practices arise in which a taxpayer performs taxable income producing activities in other States

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[4] Delaware amended its bank franchise tax statute in 2007. The provision at issue in this case remains part of the statute and the 2007 amendment added an alternative tax calculation that suffers from similar constitutional problems as the provision at issue here.

yet would still be required to apportion one hundred percent of its income to New Jersey merely because those activities did not rise to level of a "regular place of business." For example, an information service provider (such as a credit check service) could have sales people, technicians, and customer support personnel frequently visit other States but because such activity did not provide a "space" "regularly maintained" by the taxpayer, the taxpayer would be subject to tax on one hundred percent of its income in New Jersey. The same would be true for a taxpayer that actually has a sales office in another State, but the sales office is staffed with independent contractors. Because the office did not have a "regular employee[] in attendance," the taxpayer would be subject to New Jersey tax on one hundred percent of its income even if *all* of its sales were generated through this out-of-state office.

The parallels between Delaware's "branch or subsidiary" rule and New Jersey's "regular place of business" rule arbitrarily conditioning a taxpayer's right to apportion its income without regard to its activities in other States are self-evident.

B. West Virginia Prohibits Domestic Financial Organizations From Apportioning Their Income Regardless Of Their Taxable Activities In Other States.

West Virginia imposes a corporate net income tax on financial organizations. W. Va. Code § 11-24-4. In principle, West Virginia tax law permits taxpayers that have business activity that is taxable within and without West Virginia to apportion their income. However, the statute further specifies that financial

organizations that are commercially domiciled in West Virginia *are not considered subject to tax in other jurisdictions*. W. Va. Code § 11-24-7 (emphasis supplied). West Virginia's statute therefore subjects domiciliary financial institutions to tax on one-hundred percent of their income regardless of their taxable activities in other states. Once again, the analogy to Delaware's unconstitutional tax regime is self-evident.

C. Georgia Attributes All Assets Of A Domestic Corporation To The State.

Like New Jersey and West Virginia, Georgia deprives taxpayers of the right to apportion their tax base, though the taxpayer may be taxable in other States. Georgia imposes a net worth tax calculated using the total value of assets of a corporation. Ga. Code Ann. § 48-13-72. Domestic corporations are taxed on the full value of assets no matter where located. *Id; State of Georgia, Form IT-611 2007 Corporate Income Tax Forms and Instructions.*[5] The statute makes no attempt to distinguish between in-state and extraterritorial values of a commercially domiciled multistate taxpayer.

In short, it is apparent that the fundamental defect in the Delaware statute is not unique to Delaware. Several other States have taxing statutes with similar constitutional defects which reinforce the need for this Court's intervention in the present case.

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[5] Georgia permits foreign corporations to apportion their net worth tax based on the ratio of in-state assets to out-of-state assets. Ga. Code § 48-13-75.

CONCLUSION

The petition for a writ of certiorari should be granted.

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Petitioner,

v.

STATE BANK COMMISSIONER,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Delaware

BRIEF IN OPPOSITION TO LEHMAN BROTHERS BANK, FSB'S PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

Should this Court review the decision of the Delaware Supreme Court that rejected Commerce Clause and Due Process Clause challenges to the Delaware Bank Franchise Tax branch/subsidiary apportionment system as applied to a Delaware domiciliary bank, where the apportionment system as applied met the requirements of the Federal Home Owners' Loan Act, 12 U.S.C. § 1461 *et seq.*, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and later cases, particularly when subsequent amendments to the Delaware Bank Franchise Tax statute leave the decision below with no practical effect going forward?

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IN THE

Supreme Court of the United States

No. 07-1010

LEHMAN BROTHERS BANK, FSB,
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STATE BANK COMMISSIONER,
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On Petition for a Writ of Certiorari to the Supreme Court of Delaware

BRIEF IN OPPOSITION TO LEHMAN BROTHERS BANK, FSB'S PETITION FOR A WRIT OF CERTIORARI

STATEMENT OF THE CASE

Lehman Brothers Bank, FSB ("Lehman Bank" or the "Bank") is a federal savings bank chartered under the Federal Home Owners' Loan Act ("HOLA"), 12 U.S.C. § 1461 *et seq.*, with its home office located in Wilmington, Delaware. (App. 4a). Approximately 97% of the Bank's income comes from lending in the residential mortgage market, which generates income from the net interest margins between its costs of funds and borrower payments. (App. 5a, 113a n. 29). The Bank holds mortgages briefly, transferring them on average within 45-60 days to its holding company,

Lehman Brothers Holdings, Inc. ("Lehman Holdings"), which in turn securitizes the loans. (App. 5a, Pet. for Cert. at 7). The Bank earns about 4% net interest on loans while it holds them, which comprises the bulk of the total income for the Bank. (App. 5a, 113a n. 29).

Prior to 1999, Lehman Holdings funded its mortgage business through unsecured bank loans, borrowing on the commercial paper market and entering into long-term repurchase agreements. (App. 3a-4a). The borrowing costs were high and the business model was unstable, as funds become scarce with any disturbance in the global financial markets. (App. 4a, 98a). Consequently, Lehman Holdings sought to acquire a federal savings bank in which to conduct its nationwide mortgage lending operation and had been in contact with the Office of Thrift Supervision ("OTS") for a number of years in regard to its search. (App. 4a, 98a, 144a).

When the opportunity arose to acquire Delaware Savings Bank, FSB, Lehman Holdings approached OTS with a bid. Lehman Holdings purchased Delaware Savings Bank, FSB for $2 million and changed its name to Lehman Brothers Bank, FSB. (App. 4a, 144a). On June 30, 1999, OTS issued an amended Federal Stock Charter to the Bank, with a home office designated as Wilmington, Delaware, which remains its home office today. (App. 4a, 16a).

Lehman Holdings promptly moved its mortgage related business into Lehman Bank as the funds necessary to fuel the residential mortgage business were now able to be originated by, and run through, the Delaware office of the Bank. (App. 3a-5a, 98a-99a, 36a-37a). Indeed, while the source of funds for the business was limited to the volatile commercial

market prior to the acquisition, Lehman Bank was now able to secure funds from two new sources, making up at least 90% of the total source of funds for the mortgage business. (App. 36a n.73). First, since the Bank designated its home office in Delaware, the Bank gained access to the Federal Home Loan Bank ("FHLB") of Pittsburgh. (App. 4a). With this access came a ready and stable source of funds at 70 cents on the dollar at reasonable rates. (App. 98a). Second, the Bank issued certificates of deposits ("CDs") from its Delaware office. (App. 36a). The CDs were very important to the Bank and constituted a major part of its business, as they also reduced the cost of funds available for mortgage lending. (App. 4a-5a). Because only a bank may accept deposits and because Lehman Bank's sole banking office was in Delaware during the years at issue, all deposits were accepted in Delaware and CDs were issued out of the Delaware office of the Bank. (App. 36a-37a). It could do so nowhere else. *Id.* A Bank representative testified:

> [W]e sent the money to Delaware because that's where . . . our operating account was. . . . [I]t has to hit the books and records somewhere. It can't really hit your books and records in New York. It has to hit your books and records in the bank.

(App. 36a n.74). In short, with the acquisition of Delaware Savings Bank, FSB, Lehman Holdings' entire mortgage business moved to the Delaware-based Bank, with over 90% of the funds necessary to fuel that business a direct result of the Bank having its principal place of business in Delaware. (App. 36a-37a & n.73).

The stable, low-cost source of funds was more profitable than originally anticipated. (App. 149a). The Bank's net operating income before taxes, as reported to OTS as part of the required Thrift Financial Reports, revealed that the Bank's income jumped from $24,150,000 for the Quarter Ending March 31, 2000 to $161,076,000 for the Quarter ending December 31, 2003. (App. 149a-150a). Thus, the Bank enjoyed a 667% increase in its income over the four-year period in question.

In its Delaware Bank Franchise Tax ("Bank Tax") filings, Lehman Bank successively took three different positions to report less than all of its income taxable in Delaware, claiming that it was entitled (1) to a deduction for a foreign branch or operation, (2) to an unexplained reduction, or (3) to be treated as the Delaware branch of a foreign bank (App. 7a-9a). In support of the last position, and because there was no separate profit and loss statement for the Delaware office, the Bank's accountants prepared amended tax returns based on a reconstructed separate profit and loss statement, and a report in factual support of the amended returns. (App. 9a). The amended returns claimed refunds of approximately $14 million. (App. 9a). The separate accounting methodology used in preparing the amended returns was subsequently reviewed by PricewaterhouseCoopers (App. 207a-220a).

In response to Lehman Bank's tax filings, the Delaware State Bank Commissioner ("Commissioner") issued assessments and denied related refund requests. Lehman Bank disputed the assessments, and the Commissioner held a hearing to resolve the issues for the assessments and refund requests for tax years 2000 through 2003. (App. 8a-10a, 102a-104a).

Before 2006, the only apportionment method under the Bank Tax statute was on a branch/subsidiary basis.[1] Del. Code Ann. tit. 5, § 1101(a), (b). Thus, under Section 1101(a) of the Bank Tax statute, all of the net income of a federal savings bank headquartered in Delaware is taxed, unless the bank has an authorized branch in another state or has a subsidiary, in which case the income attributable to the branch or subsidiary is excluded to the extent it was taxed by another state. Conversely, under Section 1101(b), a federal savings bank with its headquarters outside the State was taxed only on the income attributable to a branch in Delaware.

Lehman Bank's home (indeed only) office and headquarters were in Delaware and it had no branches or subsidiaries anywhere. (App. 17a-19a). HOLA provides that a state may impose a tax on a federal savings association no greater than the tax imposed on similar local institutions. 12 U.S.C. § 1464(h). Therefore the Commissioner treated Lehman Bank as a domestic institution as required by HOLA, included all of its income in the Bank Tax base as required by the Bank Tax statute, sustained the assessments and denied the refunds. (App. 10a 103a). The Commissioner concluded that the imposition of tax met the requirement of HOLA and did not contravene applicable U.S. Constitutional law. (App. 103a-104a). The Delaware Superior Court affirmed on November 30, 2006. (App. 96a-134a). The Delaware Supreme Court affirmed on November 7, 2007 (modified Nov. 9, 2007). (App. 1a-95a.)

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[1] Regular business corporations are subject to the Delaware Corporation Income Tax, Del. Code Ann. tit. 30, § 1901 *et seq.*, which uses a three-factor apportionment formula based on property, payroll and sales.

Lehman Bank claims in its Petition for Writ of Certiorari that it paid substantial income taxes to other states, based on a one-page summary sheet contained in a PricewaterhouseCoopers' separate accounting review. (Pet. for Cert. at 8-12). However, the Delaware Superior Court held, and the Delaware Supreme Court affirmed, that Lehman Bank failed adequately to prove what was allegedly being taxed in other states, since the one-page document did not lay out the kind of tax being imposed nor state whether it was imposed on the same mortgage interest income or included other transactions. (App. 21a-22a, 138a).

In 2006, Delaware amended its Bank Tax statute, giving banks the option to elect a second form of apportionment, based on factors for real and tangible personal property, payroll and receipts, together with a minimum tax. Del. Code Ann. tit. 5, § 1101A. Thus, for tax years after 2006, a bank has two options to apportion its taxable income, including a method of apportionment comparable to that urged by the Bank. (App. 31a-32a).

REASONS FOR DENYING THE PETITION

The Petition for Certiorari should be denied because: (1) the decision by the Delaware Supreme Court correctly applied the applicable decisions of this Court interpreting the Commerce Clause, U.S. Const. art. 1, § 8, cl. 3, and Due Process Clause, U.S. Const. amend. XIV, § 1; (2) the decision does not conflict with decisions of this Court or other courts; and (3) the Bank Tax statute at issue has been amended, with the result that the issues raised by the Bank have no future import.

A. The Delaware Supreme Court Followed This Court's Precedents

The Delaware Supreme Court correctly followed the applicable law and precedents of this Court in concluding that the inclusion of Lehman Bank's entire net income in the Bank Tax base did not violate the U.S. Constitution.

As stated, HOLA provides that a state may impose a tax on a federal savings association no greater than the tax imposed on similar local institutions. 12 U.S.C. § 1464(h). In substance, the federal statute requires that a federal savings association be treated as a domestic institution. Since Lehman Bank had its home office and was headquartered in Delaware, the Delaware Supreme Court treated Lehman Bank as though it were a domestic institution, as required by HOLA.

Even if the dormant Commerce Clause requirements stated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), apply to the taxation of the net income of a domestic taxpayer,[2] the Delaware Supreme Court correctly held that the apportionment regime of the Bank Tax met the standards of *Complete Auto*, *supra*, and other U.S. Constitutional requirements. Since HOLA requires that the taxation of a federal savings association must track the taxation of a domestic depository, the applicable

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[2] The Delaware Supreme Court held that the *Complete Auto* test controls the Commerce Clause analysis. If this Court were to hear this case on the merits, the Commissioner would argue that the decision below should be sustained on the additional ground that the dormant Commerce Clause does not apply to a state net income tax imposed on a domestic taxpayer (as opposed to a foreign taxpayer).

standard is whether Delaware's branch/subsidiary apportionment system as applied to a domestic institution met the applicable U.S. Constitutional requirements.[3] The Delaware Supreme Court correctly concluded that it did, for the following reasons.

The Delaware Supreme Court followed the rules for the application of the dormant Commerce Clause to the taxation of business corporations that are summarized in *Complete Auto, supra*. This Court held in *Complete Auto* that a state tax will not offend the dormant Commerce Clause if: (i) the activity taxed has a substantial nexus to the state, (ii) the tax is fairly apportioned, (iii) the tax does not discriminate against interstate commerce, and (iv) the tax is fairly related to the services provided by the state. *Id.* at 279-87. Lehman Bank claims that the second requirement—fair apportionment—was not met here; it does not argue that the Bank Tax fails to comply with the three other requirements. (App. 26a n. 50).

Delaware's branch/subsidiary system of apportionment provided fair and reasonable apportionment for a bank, since a bank is a unique form of taxpayer, and banks have historically been treated as a special class of institution, due to their critical role in local, state and national economies. (App. 137a). Bank operations are controlled by strict federal and state regulation. (App. 34a, 137a-139a). Only an institution chartered by a state or the federal government can engage in banking, and only if it meets stringent

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[3] If this Court were to hear this case on the merits, the Commissioner would argue that the decision below should be sustained on the additional ground that Congress' adoption of 12 U.S.C. § 1464(h) precludes the application of any dormant Commerce Clause analysis. The Delaware Supreme Court did not accept this argument.

financial and operational requirements, including regular examination by regulatory authorities. (App. 20a, 34a, 137a-139a). Among other requirements, the critical activities of a bank, such as taking deposits and making loans, may be conducted only at authorized locations. (App. 20a, 138a-139a). Further, federal law provides that all of a federal savings bank's activities are subject to the direction of its home office. 12 C.F.R. § 545.91. Historically, banks have been taxed based upon their state of residence. *Sect. Taxation, Am. Bar Assoc., State & Local Taxation of Banks and Other Financial Institutions* (1955). Therefore, it is reasonable to base a system of apportionment on the location at which the critical activities are authorized. The branch/subsidiary apportionment provisions of the Bank Tax properly address the distinct regulation and operation of banks, and permit Delaware to administer the Bank Tax in an efficient, accurate and fair manner, without imposing additional or unfamiliar requirements on bank taxpayers.

States enjoy wide latitude in devising a constitutionally sufficient method of permitting taxpayers to divide income earned within and without the state. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978) (approving single factor apportionment formula based solely on locus of sales); *Atlantic Richfield Co. v. Alaska*, 705 P.2d 418 (Alaska 1985) (separate accounting method held constitutional). Indeed, this Court has refused to prescribe a single constitutionally required method of apportioning income. *Moorman*, 437 U.S. at 278; *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 195 (1995).

To be fairly apportioned, an apportionment system must be both internally and externally consistent.

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). The internal consistency test is met where imposition by every other state of a tax identical to the one at issue does not result in multiple tax on interstate commerce. *Jefferson Lines*, 514 U.S. at 185. Actual double taxation that is occasioned by two states having different apportionment systems is irrelevant; there is no constitutional rule against double taxation. *Moorman*, 437 U.S. at 272, 277-78. Here, if all states had adopted a bank tax with branch/subsidiary apportionment, each state would have taxed only that income earned within the state, and no more than 100% of an institution's tax base would have been taxed. Therefore, the internal consistency test was met here.

External consistency requires that the factors used in apportioning income reflect a reasonable sense of how income is generated. *Container*, 463 U.S. at 169. Delaware's branch/subsidiary system did not have to be the only method of apportioning income, nor did it have to be the "best" method in the view of any particular taxpayer. *Id.* It simply has to be reasonable. *Id.* The Bank Tax met this test. The Delaware apportionment system was based on the already existing home office, branch and subsidiary regulatory scheme. (App. 31a, 34a). The business that a bank can conduct in each jurisdiction is restricted, the places that it can conduct that business are specified, and a detailed system of regulatory accounting and financial control is imposed. (App. 34a). The comprehensive regulatory accounting system naturally lends itself as an apportionment framework. In short, a system of accounting that ensures the financial soundness of a bank provides a logical basis to apportion its income.

The branch/subsidiary apportionment system fairly apportioned the Bank's income and reasonably reflected how such income was earned. The Bank's home office during the years at issue was Delaware, which is the place from which all of its activities were directed. (App. 4a, 16a). 12 C.F.R. § 545.91. As a result, Lehman Bank was a member of the FHLB system by virtue of being a federal savings association and it was able to receive advances from the FHLB of Pittsburgh by virtue of being a Delaware-based bank, thus providing a low-cost stable source of funds for the Bank's business. (App. 4a, 37a, 98a). 12 U.S.C. §§ 1429, 1430; 12 C.F.R. § 950.2. Lehman Bank was able to borrow from the public through FDIC-insured deposits. (App. 36a-37a). The Bank accepted all insured deposits in Delaware, as it is the only place it could legally do so. (App. 36a-37a). The Bank admitted that deposits had to "hit your books and records in the bank", that is, in Delaware. (App. 36a n.74). The cost of funds dropped precipitously from the time when the mortgage business was operated by Lehman Holdings, because Lehman Bank obtained access to stable, low-cost funding only available to it as a Delaware-based bank. In fact, the new funding supported virtually all of the Bank's lending activities, generating almost all of its income. (App. 36a, 36a n.74). This benefit, derived exclusively from Delaware, is what the tax reaches, and the income earned from this funding is reasonably included in the measure of that benefit. It is reasonable to attribute income generated by deposits to the place the Bank is given its franchise to operate, the sole location at which deposits can be accepted, and the location of the home office that determines from what FHLB regional office it can borrow. (App. 36a-37a). Accordingly, the Bank's funding and

income generated therefrom is reasonably attributable to Delaware.

Lehman Bank and amici curiae, Council on State Taxation ("COST")[4] and U.S. Bancorp, argue that Delaware taxes on an unapportioned basis income which other states are taxing on an apportioned basis, and that the alleged double taxation render the Bank Tax unconstitutional. They are incorrect on both counts. Delaware does not impose an unapportioned tax. The Bank Tax is apportioned based on branches and subsidiaries. If the Bank chooses to conduct its income-generating activities in such a way that the Bank fails to qualify for the Bank Tax apportionment factors, the result does not violate the Commerce Clause. So long as an apportionment system is both internally and externally consistent—which the Bank Tax is, as discussed above—either the risk of, or even actual, multiple taxation occasioned by differences in state apportionment systems does not invalidate any particular state's tax. *Moorman*, 437 U.S. at 272, 277-78; *Container*, 463 U.S. at 192-93. As stated by this Court in *Moorman, supra*, "[s]ome risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income." *Moorman*, 437 U.S. at 278. This Court has refused to require a state "to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." *Container*, 463 U.S. at 193. Moreover, this Court has refused to find that the Commerce Clause requires national uniform rules for the division of income, *Moorman*,

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[4] While Lehman Bank is not a member of COST, an affiliated entity, Lehman Brothers, Inc., is a member.

437 U.S. at 279-80, and has refused to base the validity of any one state's tax on "the shifting complexities of the tax codes of 49 other States." *Armco Inc. v. Hardesty*, 467 U.S. 638, 645 (1984).

Even if Lehman Bank and amicus curiae were correct on this legal point, the issue is not properly positioned for disposition by this Court, as Lehman Bank failed to prove below that it was subject to double taxation. The courts below held that Lehman Bank's proof was inadequate and failed to meet its burden of showing double taxation. (App. 21a-22a, 38a).

Lehman Bank also argues that a separate accounting analysis by its accountants shows that the Bank Tax reached too much of Lehman Bank's income. The Delaware Supreme Court correctly rejected the argument. Separate accounting is neither constitutionally required nor an acceptable standard for measuring income against which other methods can be compared. *Container*, 463 U.S. at 190; *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 223 (1980). *See Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 317 (1994). In any event, the Delaware courts found that Lehman Bank failed to present a credible separate accounting analysis. (App. 21a-22a, 38a, 131a-132a).

For reasons similar to those discussed above, there was no violation of the Due Process Clause. Lehman Bank cites cases for the proposition that income must be rationally related to the taxpayer's in-state activities, such as *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), *Exxon*, *supra*, *Moorman*, *supra*, and *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). However, as discussed above, the income taxed by Delaware was rationally related

to Delaware, when the two most important factors in producing that income were access to the FHLB of Pittsburgh and the ability to issue insured CDs, both of which were directly attributable to the home office in Delaware.

Lehman Bank and amici argue that only 2% of the Bank's income was earned in Delaware, as though the 2% ratio were a fact. It is not a fact. Rather, the 2% ratio is an argument that the Bank made but failed to prove below. The Commissioner properly rejected the argument that the separate accounting method utilized by Lehman Bank accurately measured the income of the Bank with its home and only office in Delaware, for the reason (among others) that it ignores the unique nature of a bank and the critical powers to accept deposits and borrow from the FHLB, both of which depended entirely on the Bank's Delaware home office. (App. 153a-154a).

B. The Delaware Supreme Court Decision Does Not Conflict With Precedent Of This Court

The decision of the Delaware Supreme Court does not conflict with prior decisions of this Court. There is no material difference between the Delaware Supreme Court decision and the cases cited by Petitioner and its amici regarding the principles applicable when considering a challenge to the apportionment scheme of a statute. There are differences in the identity and form of the taxpayer, the nature of the tax, and the facts and circumstances among the cases. Consequently, the discussion and the result in any particular case may be different, but that is because the facts are different, not because the legal principles applied are different.

The Delaware Supreme Court decision does not conflict with this Court's modern cases on the application of the Commerce Clause to interstate commerce: *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000), *Goldberg v. Sweet*, 488 U.S. 252 (1989), *Container, supra*, *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), and *Complete Auto, supra*. The cases hold that a state must fairly apportion the income of a foreign business corporation engaged in interstate commerce, but they do not dictate how a state must apportion. None of the cases cited involved a bank, an entity required by federal law to be treated as a domestic institution, or even a domestic corporation. Delaware does not take the position that it need not apportion its Bank Tax; it does apportion the Bank Tax, even for domestic banks, on a branch/subsidiary basis. The Delaware Supreme Court correctly concluded that the branch/subsidiary apportionment scheme was fair and reasonable, for the reasons discussed above.

With no cases involving a bank, Lehman Bank and the amici cite older gross receipts and property tax cases. For example, *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948), involved a gross receipts tax imposed on gross income from utility services, specifically, bus service. It held that New York could not impose an unapportioned tax on receipts from bus services that were performed out-of-state. Similarly, *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939), involved a tax on gross receipts for the privilege in engaging in business activity, *J.D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938), involved a tax on gross income from business and invested capital, and *Meyer v. Wells Fargo & Co.*, 223 U.S. 298 (1912), involved a tax on gross receipts of public-service corporations. Lehman Bank is not

subject to a gross receipts tax. Further, as discussed above, the Bank Tax is not unapportioned, unlike many of the gross receipts taxes in the cases cited. Finally, even if these cases were applicable, the fact that some portion of a company's activities take place outside the taxing state does not mean that such state is prohibited from taxing 100% of the gross receipts from such activities. See *Ford Motor Co. v. City of Seattle*, 156 P.3d 185, 190-192 (Wash. 2007), *cert. denied*, --- U.S. ---, No. 07-623, 2008 WL 423568 (Feb. 19, 2008).

Norfolk & Western Railway Co. v. Missouri State Tax Commission, 390 U.S. 317 (1968), was a property tax case, holding that Missouri could not impose a tax on rolling stock on a miles-apportionment formula basis that was widely at variance with an actual count of the items and values of rolling stock present in the state. Property taxes were also an issue in *Northwest Airlines v. Minnesota*, 322 U.S. 292 (1944), *Central Railroad Co. v. Pennsylvania*, 370 U.S. 607 (1962), *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952), *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169 (1949), *Wallace v. Hines*, 253 U.S. 66 (1920), *Union Refrigerator Transit Co. v. Kentucky*, 199 U.S. 194 (1905), *Fargo v. Hart*, 193 U.S. 490 (1904), *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897) and *Pullman's Palace Car Co. v. Commonwealth of Pennsylvania*, 141 U.S. 18 (1891). *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), involved the taxation of property owned by a foreign nation, implicating additional requirements and considerations under the Foreign Commerce Clause that are not applicable here. *Japan Line*, 441 U.S. at 446-51.

Lehman Bank and the amici argue that the gross receipts and property tax cases require apportionment of a net income tax, but this Court has never so held. In any event, income taxes are different than gross receipt taxes and property taxes. The apportionment of net income is, as this Court has observed, akin to "slicing a shadow." *Container*, 463 U.S. at 192. A gross receipt, by contrast, is an actual event and personal property can be geographically located, even if it moves around. Net income, however, must be attributed to a jurisdiction by other factors, which is why this Court gives wide leeway to what factors a state chooses. *Moorman*, 437 U.S. at 278; *Jefferson Lines*, 514 U.S. at 195. Here, the Bank Tax was apportioned, based on branches and subsidiaries. Given the unique nature of a bank and its particular powers, the attribution of net income with respect to those factors is eminently reasonable for the reasons discussed above.

Jefferson Lines, supra, actually permitted an unapportioned tax, but it has no application here because it was a sales or consumption-type tax case. Likewise, *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938), permitted an unapportioned tax, but using an analysis that pre-dated *Complete Auto, supra*.

Lehman Bank also argues that the decision below contravenes *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). This argument too is incorrect. In *Kraft, supra*, this Court found an Iowa corporate income tax statute to be facially discriminatory, in contravention of the Commerce Clause tests in *Complete Auto, supra*, because it denied a dividends-received deduction for dividends from foreign subsidiaries, but granted the deduction

for dividends from domestic subsidiaries. This Court rejected Iowa's argument that its discriminatory taxing scheme was saved by showing that the taxpayer could have avoided the result by changing the form in which it conducts its business—that is, by having its subsidiaries incorporated in the United States instead of overseas. Lehman Bank has not argued, and no court has held, that the Bank Tax is discriminatory in nature. (App. 26a n. 50). Second, Lehman Bank incorrectly argues that the Bank Tax's branch/subsidiary apportionment system is based on the *form* in which an institution conducts its business, instead of how the income was earned. As discussed above, a bank is a governmentally franchised, geographically restricted and regulated business that can conduct the activities that give rise to its income only at a location authorized by the regulator. Thus, unlike the choice of where to incorporate a subsidiary, the Bank's decision to have or not have an authorized branch or subsidiary in a state other than Delaware was not simply a choice as to the *form* in which business would be conducted. Rather, it was a conscious choice by the Bank as to the location in which the activities giving rise to the income sought to be taxed by Delaware would be conducted; namely, the issuance of CDs and the obtaining of loans from the FHLB at low rates that allowed the Bank to earn significant interest income from the net interest margins between the cost of funds and rates charged on mortgages. For these tax years, Lehman Bank had its headquarters and home office in Delaware. It had no branch or subsidiary elsewhere and had no authority from the federal regulators to conduct its banking functions outside Delaware, and therefore did not and could not earn the income in question in a state other than Delaware.

Thus, Delaware's taxation of the Bank's entire net income under the Bank Tax statute is proper and consistent with this Court's decisions.

C. The Delaware Supreme Court Decision Does Not Conflict With Decisions Of Other States

Neither does the decision of the Delaware Supreme Court conflict with the decisions of other states. Again, there are differences between the present case and the cited cases in regard to the identity and form of taxpayer, the nature of the tax, and other facts and circumstances. But there is no conflict between the constitutional principles identified and applied by the Delaware Supreme Court and the principles identified and applied in each of the cases cited by Petitioner and its amici. Lehman Bank cites *Northwest Energetic Services, LLC v. Franchise Tax Bd.*, 2008 Cal. App. LEXIS 162 (2008), *Northwood Construction Co. v. Township of Upper Moreland*, 856 A.2d 789 (Pa. 2004), *cert. denied*, 544 U.S. 962 (2005), *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108 (Pa. 2003), *Southern Pacific Transportation Co., Inc. v. Department of Revenue*, 44 P.3d 1006 (Ariz. Ct. App. 2002), *General Motors Corp. v. City and County of Denver*, 990 P.2d 59 (Colo. 1999), and *General Motors Corp. v. City of Los Angeles*, 486 P.2d 163 (Cal. 1971). None of these cases involved a bank, none of them involved Section 1464(h) of HOLA and none of them involved a taxpayer organized under the laws of the taxing state. In addition, *City of Winchester v. American Woodmark Corp.*, 471 S.E. 2d 495 (Va. 1996), did not involve a bank, and *City of Modesto v. National Med, Inc.*, 27 Cal. Rptr. 3rd 215 (Cal. Ct. App. 2005), did not even interpret the Commerce Clause.

D. The Decision Below Has No Practical Effect Going Forward

A 2006 amendment to the Bank Tax statute gives a bank taxpayer the option to elect a second form of apportionment, based on factors for real and tangible personal property, payroll and receipts, together with a minimum tax. (App. 31a-32a). Del. Code Ann. tit. 5, § 1101A. Since a bank can now opt out of the apportionment system complained of here, the decision by the Delaware Supreme Court has no practical effect going forward. Indeed, the Petitioner conceded that the pre-amendment Bank Tax was the only one of its kind in the country, stating that "Delaware is the only state" to have such an "idiosyncratic statute". (Pet. for Cert. at 21). While Delaware disagrees with the negative characterization of the statute, by Petitioner's own admission, there is no other like it in the country, and in Delaware it is now merely one of two options. Therefore, this Court need not review the decision below.

Amicus U.S. Bancorp argues differently that the same issue raised by Lehman Bank is implicated under the laws of New Jersey, West Virginia and Georgia, but the argument has no merit. All of the statutes cited impose a tax on a wide array of entities, not just banks or an institution otherwise required by federal law to be treated as a domestic financial institution. N.J. Stat. Ann. §§ 54:10A-2, 54:10A-4; W. Va. Code §§ 11-24-3a, 11-24-4; Ga. Code Ann. §§ 48-13-70, 48-13-72. In addition, as to the West Virginia tax, the rule denying apportionment to a financial organization commercially domiciled in West Virginia is repealed for tax years beginning on or after January 1, 2009. S.B. 749, 78th Leg., 1st

Sess., Chapter 247, Acts, Regular Session, 2007 (W. Va. 2007).

Amicus COST argues that the issue raised in this case is somehow "intensified" by the question of whether economic presence is sufficient to confer nexus on a taxpayer. The economic nexus issue is not relevant here. Lehman Bank is physically located in Delaware; no one has ever argued that the Bank does not have nexus with Delaware. Simply put, intensification of an unrelated issue is not a reason for granting review in this case.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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In The

Supreme Court of the United States

LEHMAN BROTHERS BANK, FSB,

Petitioner,

v.

STATE BANK COMMISSIONER,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Delaware

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STATEMENT OF THE CASE

This replies to Respondent's Brief in Opposition ("Br. in Opp."), wherein Respondent asks this Court to sanction the taxation by Delaware of 100% of the income of Lehman Brothers Bank, FSB ("Lehman" or "Bank"), notwithstanding that it operates a nationwide mortgage banking business. Lehman was denied the right to apportion its income even though nearly all of its income-generating activities took place outside Delaware. Taxing 100% of the Bank's income, and disregarding its activities in other states, violates both the Commerce and Due Process Clauses of the U.S. Constitution and is contrary to long-standing Supreme Court precedent.

This case presents a conflict between an obsolete tax statute and modern banking practices. The statute reflects an archaic regulatory regime that required banks to organize in specified forms, such as through branches and subsidiaries. Modern banking practices, however, have liberalized that regulatory regime and permit banks greater leeway in how they carry out their activities. Under Delaware law, only banks that conduct their multi-state activities through branches or subsidiaries can apportion their income, regardless of where that income is earned. Consequently, Lehman was denied the right to apportion notwithstanding that it earned nearly all of its income through out-of-state activities that were not conducted utilizing branches or subsidiaries. By taxing all of Lehman's income, the Delaware statute violates the Commerce Clause and Due Process

Clause requirement that a rational relationship must exist between the income taxed and the activities conducted within the state. Further, a state may tax only that part of a corporation's income that is fairly attributable to its income-producing activities in the state.

In urging this Court to deny certiorari, Respondent erroneously portrays Lehman as conducting its entire mortgage business in Delaware. Respondent's depiction of Lehman's activities is based not on the factual record, but merely on the designation of the Bank's "home office" in Wilmington, Delaware. The underpinning of Respondent's position is a federal banking regulation (12 C.F.R. § 545.91), which provides that a federal savings bank "shall be subject to direction from the home office." The "home office" designation, in turn, determines which of the twelve regional Federal Home Loan Bank ("FHLB") offices provides funding to the Bank. Br. in Opp. 9, 11. Although the designation of a "home office" has consequences for bank regulatory purposes, it has no relevance as to where Lehman earned its income, which is exactly what the Commerce Clause and Due Process Clause "fair apportionment" requirement is intended to measure.

Respondent states that the designation of Wilmington, Delaware as the location of Lehman's "home office" gave the Bank access to "the FHLB of Pittsburgh." Br. in Opp. 3, 11. But the Delaware "home office" designation is not what gave the Bank access to FHLB funding itself. Rather, the Bank's status as a

federally-chartered savings bank – and not the Bank's location or regulatory "home office" – allowed it access to funding from the FHLB system. Although the Bank obtained its funding from the Pittsburgh office of the FHLB (which covered Delaware, Pennsylvania and West Virginia), it would have been entitled to the very same funding, at the same rates, from any one of the other eleven FHLB offices had its "home office" been in another state.

Lehman furnished Respondent with a study prepared by PricewaterhouseCoopers LLP, an independent CPA firm, confirming that the Bank paid more than $106 million in state and local income taxes to other jurisdictions on the same income being taxed by Delaware. Respondent notes that the Delaware court found this proof inadequate. Br. in Opp. 6. As Lehman pointed out in its Petition, the State Bank Commissioner never questioned the Bank's undisputed proof of $106 million in taxes paid to other jurisdictions. Furthermore, an expert witness from PricewaterhouseCoopers who testified about those income taxes was never questioned by Respondent on this point. By taxing 100% of the Bank's income, Respondent has created multiple taxation. More fundamentally, it is the *risk* of multiple taxation, rather than proof of *actual* multiple taxation, that the "fair apportionment" mandate protects against. *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980).

REASONS FOR GRANTING THE PETITION

I. THE DELAWARE COURT'S DECISION STANDS IN DIRECT CONFLICT WITH THE FAIR APPORTIONMENT MANDATE REQUIRED UNDER *COMPLETE AUTO*

Respondent claims that taxing 100% of Lehman's multi-state income satisfies the "fair apportionment" requirement of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[1] Br. in Opp. 7. Not surprisingly, neither Respondent nor the Delaware court has identified a single decision of this Court sanctioning that result. Although the Delaware Supreme Court held that the Bank was entitled to the protections of *Complete Auto*, the decision is actually a significant retreat from *Complete Auto*.

Respondent makes several references to the testimony of a Bank representative that the FHLB funding furnished to Lehman Bank "has to hit [the] books and records in the bank," Br. in Opp. 3, 11, suggesting that this should determine where the Bank's interest income was earned. While the precise meaning of "hitting the books" for accounting purposes is unclear, this Court has recognized that where income is sourced for accounting purposes is not determinative of where that income is earned. *See,*

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[1] Respondent's brief reveals that he believes a state constitutionally may deny apportionment to any Delaware domiciliary or to any federally-chartered bank. *See* Br. in Opp. 7 n.2 and 8 n.3.

e.g., Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980). Furthermore, Respondent has advanced a principle that would source income based on where money is borrowed from. The fundamental defect in Respondent's position is that sourcing income based on where money is borrowed ignores all other activities which generate that income. Respondent tries to defend his position denying apportionment by arguing that "but-for" the borrowed funds, Lehman would have no income. Br. in Opp. 11. However, the Bank's income was generated by a series of integrated and interdependent transactions, requiring not only a source of funds, but also the expertise of knowing how to use those funds. In order for the Bank to earn its income, appraisals had to be made of real estate, the creditworthiness of borrowers needed to be determined, documents needed to be prepared and processed, decisions had to be made about how much to invest and in what types of mortgages, and loans had to be secured by real property located outside Delaware. Any one of these necessary functions can be carved out and, if viewed in isolation, can be said in a "but-for" sense to be the key to generating the interest income. This "but-for" reasoning violates the Court's external consistency doctrine, which requires that an "apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159, 169 (1983).

Following the logic of the Delaware court's decision, any state where any one of these activities

occurs could be viewed as the source of the interest income. If every state with a connection to an activity that contributed to the generation of the mortgage interest were to adopt the court's reasoning, the Bank would be taxed on 100% of its income by numerous states. No state, including Delaware, should tax the Bank on all of its income when activities in numerous states were essential to the generation of the mortgage interest. To be sure, every state in which such activities take place is entitled to tax a fair share of such interest. But whatever Delaware's fair share is, it certainly is not 100%, especially in light of the fact that only 2% of the Bank's activities occurred in Delaware.[2]

Consider a Delaware shoe store that borrows money from a bank in Pennsylvania to finance its purchase of inventory in Maryland, which it sells at its store in Delaware. Under orthodox principles of state taxation, and the law in every state with an income tax, none of the income from the sale of the shoes would be sourced to Pennsylvania merely because the bank from which it borrowed money to finance its inventory was located there. In *Exxon Corp.*, 447 U.S. at 230, this Court rejected a multistate corporation's attempt to avoid apportionment on the grounds that its oil exploration and production

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[2] A study prepared by the CPA firm of Ernst & Young LLP, and verified by PricewaterhouseCoopers LLP, confirmed that on average only 2% of the Bank's activities occurred in Delaware. App. 220a.

activities took place entirely outside the state, with the Court noting the "geographic location of such raw materials does not alter the fact that such income . . . is subject to fair apportionment among all States to which there is a sufficient nexus with the interstate activities of the business." Although the Bank's FHLB funding may be important to its mortgage banking business, even if the funding was derived "through" Delaware (which the Bank disputes), it was only one component of how the Bank earned its income and does not justify the denial of *any* apportionment.

Respondent claims that the Delaware "branch/subsidiary apportionment system" satisfies the Commerce Clause because it is based on a bank regulatory system which limits where certain banking activities may be conducted. Br. in Opp. 9. Respondent is mistaken in several respects. First, beginning in 1990, the United States Office of Thrift Supervision ("OTS") permitted a federal thrift to carry on certain activities out of state, particularly mortgage banking related activities, without having to do so through a branch or subsidiary structure. 54 FR 50613 (Dec. 8, 1989). Since 1992, a federal thrift (such as Lehman) may, without notice to the OTS, engage in mortgage banking related activities, such as originating and servicing loans and managing and selling real estate owned by the thrift, through an agency office located in a state other than a state in which its "home office" or branches are located.

To the extent the Delaware law permits apportionment for income from out-of-state activities, it

recognizes only activities conducted through out-of-state branches and subsidiaries, notwithstanding the OTS' intent to the contrary to allow federal thrift activities at other types of offices. The Delaware law ignores not only the OTS' liberalized policies, but disregards the economic realities of the structure of the mortgage banking business. It directly conflicts with the modern banking practices allowing a mortgage banking business to be conducted in out-of-state agency offices or loan production offices. Similarly, Respondent's argument that banks should be treated differently for Due Process and Commerce Clause purposes is completely diminished by the realities of the modern day banking business.

In *Goldberg v. Sweet*, 488 U.S. 252, 254 (1989), this Court addressed a challenge to Illinois' sourcing of receipts from interstate telephone calls "against a backdrop of massive technological and legal changes in the telecommunications industry" following the deregulation of the industry. In rejecting the taxpayers' position against the sourcing of telephone call receipts based on customer billing addresses, this Court found it "significant that Illinois' method of taxation is a realistic legislative solution to the technology of the present-day telecommunications." *Id.* at 264. Here, Delaware's antiquated "branch/subsidiary apportionment system" is no longer practical for the modern banking industry, and taxing 100% of a bank's multi-state income violates external consistency.

While Respondent is correct that a state "enjoy[s] wide latitude" in fashioning a constitutionally acceptable method for apportioning income within and without a state, Br. in Opp. 9, such wide latitude does not authorize taxation of *all* income of a corporation that engages in substantial income-generating activities outside the taxing state.[3] Respondent cites this Court's decisions in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274 (1978) and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 195 (1995). If anything, these decisions undermine Respondent's position that its "branch/subsidiary apportionment system" is constitutional. *Moorman* involved whether Iowa's single sales factor, rather than a three-factor apportionment formula, was constitutional, not whether Moorman was entitled to *any* apportionment. *Jefferson Lines* actually reaffirmed that an income tax must "be apportioned to reflect the location of the various interstate activities by

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[3] Respondent points to *Ford Motor Co. v. City of Seattle*, 156 P.3d 185, 190-92 (Wash. 2007), *cert. denied*, 128 S. Ct. 1224 (2008), as support for the argument that even if "some portion" of a company's activities take place outside the taxing state, it does not prohibit that state from taxing 100% of the Company's gross receipts. Br. in Opp. 16. The gross receipts tax in that case was imposed on Ford's gross receipts from sales made to dealers located *within the taxing jurisdiction*. *Id.* at 194. This is factually distinguishable from this case, which involves the taxation of 100% of the Bank's income earned throughout the United States.

which it was earned." 514 U.S. at 190.[4] Neither case sanctions the denial of apportionment under a state income tax to a multi-state business, particularly where other states had the right to and did tax a portion of the income of that business.

Finally, the Delaware statute violates *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), which held that unconstitutional discrimination is not cured merely because the taxpayer could have structured its business in a way as to avoid that discrimination. Respondent claims that *Kraft* is distinguishable, Br. in Opp. 17-18, but its claims ring hollow. First, Respondent argues that unlike the taxpayer in *Kraft*, Lehman does not claim that the Delaware tax is discriminatory. There is nothing in the language of that decision, and no basis in logic, to artificially limit *Kraft's* holding solely to violations of the "discrimination" prong of the four-part Commerce Clause requirements of *Complete Auto*. Respondent's other ground for disregarding *Kraft* – that the Bank's decision whether or not to establish a branch or subsidiary was not a choice as to the *form* of doing business but rather as to its *location* – is equally unsupportable.

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[4] Curiously, Respondent argues that this Court "has never so held" that the Commerce Clause "fair apportionment" requirement applies to a net income tax, Br. in Opp. 17, a claim that is contrary to such decisions as *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994) and *Amerada Hess Corp. v. Director, Division of Taxation*, 490 U.S. 66 (1988).

Respondent has denied apportionment to Lehman *precisely because* it did not conduct its activities in the form of a branch or subsidiary.

II. SUBSEQUENT AMENDMENTS TO THE DELAWARE BANK TAX LAW HAVE NO BEARING ON WHETHER THE DECISION BELOW SHOULD STAND

Respondent argues that the Delaware Supreme Court decision has "no practical effect going forward" because Delaware amended its bank tax law for tax years beginning after December 31, 2006. Br. in Opp. 20.

Respondent is incorrect for several reasons. First, the Delaware statute at issue remains part of the current law, and therefore remains an ongoing constitutional issue. Furthermore, although the amendment does provide an elective alternative tax calculation which allows apportionment of an income tax, that right to apportion income out of Delaware comes at a steep price: a minimum $2 million "relocation benefit tax" which is required to be paid *in addition* to the tax on income. Accordingly, that amendment suffers from similar constitutional problems as the provision at issue.[5] In addition, even if

[5] Among the constitutional defects of the 2006 amendments (which were enacted to encourage a major Delaware-based bank to retain its bank charter in Delaware) are that (i) it provides for an arbitrary $2 million minimum "location benefit tax," irrespective of the bank's level of in-state activity and (ii) the calculation

(Continued on following page)

the amendments did cure the constitutional defects of the statute prospectively, the Delaware Supreme Court decision remains in direct conflict with this Court's precedent under the Commerce and Due Process Clauses.

In the Motion to Dismiss the Writ of Certiorari as Improvidently Granted in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the state also claimed that the Court should not accept certiorari because the issue "[was] of no continuing importance," 1995 WL 357491 at *3, because the tax at issue had subsequently been repealed. This Court refused to dismiss the writ of certiorari, noting that there remained a "justiciable controversy" despite the tax repeal "[b]ecause the repeal has no retroactive effect . . . it does not effect the tax years at issue in this litigation." *Fulton Corp.*, 516 U.S. at 328 n.1. Similarly, this Court should reject Respondent's argument that subsequent amendments to the Delaware bank tax, effective after the years in issue, have diminished the Delaware court decision's constitutional significance and the urgent need for this Court to step in.

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of the "location benefit tax," which is based on the bank's owned property, excludes from the tax base only those assets attributable to the operations of an out-of-state branch. Del. Code Ann. tit. 5, § 1101A(d). Furthermore, the 2006 amendments which offer this alternative tax calculation deny the right to utilize the alternative tax method to any taxpayer with an unpaid assessment (such as Lehman, by reason of its constitutional challenge to that assessment). 75 Del. Laws, c. 223, § 5 (2006).

CONCLUSION

Respondent has not shown that denying the right to apportion income to a multi-state business conducting nearly all of its activities outside Delaware satisfies the constitutional "fair apportionment" requirement under *Complete Auto*. Respondent's antiquated "branch/subsidiary apportionment system," which does not reflect present day banking practices, does not cure this constitutional infirmity. Moreover, Respondent cannot constitutionally source the income of a multi-state business based solely on where funds are borrowed while ignoring the substantial income-generating activities conducted in other states. The Delaware Supreme Court decision conflicts with the long-standing decisions of this Court, as well as with decisions from the highest courts of other states.

The Petition for a Writ of Certiorari should be granted.

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